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**PERFORMANCE AND MARKET
IMPLICATIONS OF ISLAMIC BANKING. (A
Case Study of Bank Islam Malaysia Berhad)**

by

Radiah Abdul Kader

**A thesis submitted in partial fulfilment
of the requirements for the degree of
Doctor of Philosophy**

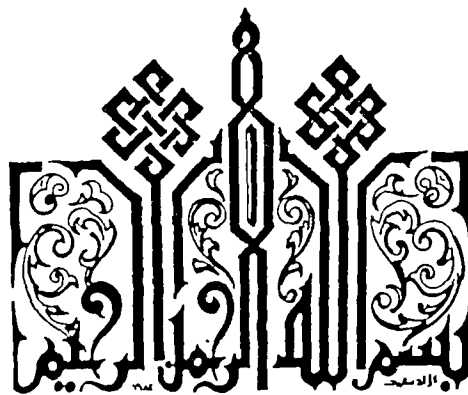
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IN THE NAME OF ALLAH,
THE MERCIFUL,
THE MERCY-GIVING

Abstract

The focus of this thesis is a case study of Bank Islam Malaysia Berhad; the first fully-fledged Islamic bank in Southeast Asia. A key feature of this thesis is an assessment of Bank Islam over the first eight years of its operation. The bank was established in 1983. Since it is approaching the end of its ten year monopoly in the supply of Islamic banking services in the Malaysian market it is pertinent to look at its performance to this date. Information on performance is relevant both to Bank Islam and also to potential competitors who are making decisions about entering this market post 1993. Given the economic climate and the financial system in which it was forced to operate, one main thrust of this thesis is to examine the extent to which Bank Islam has succeeded in offering an alternative form of banking in a well-established interest-based environment. The other key element of this thesis is a survey of Muslim bank depositors in Malaysia. This survey was designed to try and understand why, in a country whose population is predominantly Muslim (53 per cent), Bank Islam has only captured a very marginal share of deposits. After eight years in existence, only 2 per cent of total commercial bank deposits were held in Bank Islam. It raises the question of whether Malaysian Muslims are not depositing in the banking system at all or whether they desire banking services but are not primarily motivated by the religious factor to bank with Bank Islam. The statistical analysis of the survey results is generally concerned with three main aspects: (i) to test several hypotheses about the depositors of Bank Islam including those considered by earlier researchers on Islamic banking in Malaysia; (ii) to identify the main bank selection decisions of Muslim depositors in Malaysia; specifically the depositors of Bank Islam and the depositors of the conventional banks; (iii) to examine the market implications of the results obtained in order to gain some insight to how Islamic banking can capture a bigger segment of the market of Muslim depositors.

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Declaration

I hereby declare that this thesis entirely results from my own investigation and that no part of it has previously been submitted for any degree at this university or any other university.

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Chapter I

Introduction

1.1 Statement of the Problem

The emergence of Islamic banks in the 1970s set the beginning of a new era in the financial system of the Muslim world. More than sixty Islamic banks can be found all over the world today. With the exception of Iran and Pakistan where the whole banking system has been Islamized, the other Islamic banks operate in dual financial systems side by side with the interest-based banks.

This thesis focuses on Islamic banking in Malaysia. Only one Islamic bank; namely Bank Islam Malaysia Berhad has been established in Malaysia since 1983. Since the bank is coming to the end of its ten year monopoly in the supply of Islamic banking services; it is likely to lose its potential position in the banking sector.

A key feature of this thesis is an assessment of Bank Islam over the first eight years of its operation. It is pertinent to look at the performance of Bank Islam to this date. Whilst information on performance is relevant both to Bank Islam and its decisions regarding future marketing strategies; it is also relevant to potential competitors in the banking sector who are making decisions about entering this market post 1993.

The other key element of this thesis is a survey of Muslim bank depositors in Malaysia. The survey was designed with a view to try and understand why, in a

country whose population is predominantly Muslim (53 per cent), Bank Islam has only captured a very marginal share of deposits. After eight years in existence only 2 per cent of total commercial bank deposits were held in Bank Islam. It raises the question of whether Malaysian Muslims are not depositing in the banking system at all or whether they desire banking services but are not primarily motivated by the religious factor to bank with Bank Islam.

1.2 Outline of Chapters

The thesis develops as follows:

It starts with a survey of the overall Islamic economic system focusing on the justification for the system to Muslims and secondly on the issue of the prohibition of *riba* which forms the foundation of Islamic banking. (Chapter II). The study then proceeds through a literature survey of the development of Islamic banking both in theory and practice (Chapter III); to a presentation of the Malaysian economy and the Malaysian financial system - the context in which Islamic banking was developed in Malaysia (Chapters IV and V).

The actual development of Islamic banking in Malaysia is the story of the evolution and framework of Bank Islam Malaysia Berhad. This is the focus of Chapter VI. The performance of Bank Islam given the economic climate and the financial system in which it was forced to operate is assessed in Chapter VII. The main thrust is to examine the extent to which Bank Islam has succeeded in offering an alternative form of banking in a well-established interest-based environment; and if so how has it achieved it? Has its operation been geared purely with the economic objective of profits or does its Islamic character differentiate it from the other commercial banks in the country?

The survey of Muslim bank depositors is the focus of Chapters VIII and IX. Whilst Chapter VIII details the research methodology, Chapter IX reports the findings and an interpretation of them. The statistical analysis in Chapter IX is generally concerned with three main aspects:

1. to test several hypotheses about the depositors of Bank Islam including those considered by earlier researchers on Islamic banking in Malaysia.
2. to identify the main bank selection decisions of Muslim depositors in Malaysia; specifically the depositors of Bank Islam and the depositors of the conventional banks.
3. to examine the market implications of the results obtained in order to gain some insights on how Islamic banking can capture a bigger segment of the market of Muslim depositors.

Chapter X concludes the thesis with an overall summary, an assessment of the future prospects of Islamic banking in Malaysia and recommendations for further research.

1.3 Glossary of Islamic Concepts

The following Islamic concepts are given full definitions to clarify their meaning and avoid misconceptions.

Al-Bai Bithamin Ajil: Sale against deferred payment.

Falah: well-being attained by the satisfaction of both the material and the spiritual needs of the human personality.

Ijarah: leasing.

Mudarabah: trustee profit-sharing; an agreement between two or more persons whereby one or more of them provide finance, while the other provides entrepreneurship and management to carry out a business venture with the objective of earning profits. The profit is shared by them in an agreed proportion. Any losses will be borne only by the provider(s) of finance in proportion to their share in total capital.

Murabahah: sale at a specified markup or profit margin.

Musharakah: equity participation.

Qard al-Hasan: benevolent or interest-free loan.

Quran: The Holy Book of the Muslims consisting of the revelations made by God to the Prophet Muhammad, peace be upon him. The Quran lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Muslim way of life. In all references to the Quran in the text (e.g., 30:41), the first number refers to the *surah* or chapter and the second to the *ayah* or verse.

Riba: a 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for a loan. It is thus equivalent to interest.

Shariah: refers the divine guidance as given by (i) the *Quran* (the original source from which all principles and ordinances of Islam are drawn), (ii) the *Sunnah* (the sayings and actions of the Prophet (peace be upon him)), (iii) the *Ijtihad* (exercise of judgement based on the *Quran* and the *Sunnah* and (iv) the *ijma* the legal consensus.

Sunnah: The second chief source of Islamic law. It refers essentially to the examples of the Prophet Muhammad, peace be upon him, as indicated by his practise of

the faith. The only way to know the Sunnah is through the collection of *ahadith*.

Surah: A chapter of the Quran.

Tawhid: affirmation of the unity and oneness of God, the cardinal Islamic concept.

Zakat: The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy.

Zulm: a comprehensive term used to refer to all forms of inequity, injustice, exploitation, oppression and wrongdoing, whereby a person either deprives others of their rights or does not fulfil his obligations towards them.

Chapter II

The Economic System of Islam

2.1 Introduction

No banking system can exist in an ideological vacuum. The conventional banking system dominating the financial world today has been fashioned according to the spirit of capitalism in which the rate of interest plays an important role. Islamic banking is no exception. Muslim economists unanimously agree that an Islamic banking system in its pure form can only be envisaged in an Islamic economy. As a prelude to the study of Islamic banking this chapter attempts to provide the justification for Islamic banking by examining the philosophical foundation and conceptual framework of such an economy. To achieve this aim the chapter is divided into the following main sections. Sections 2 and 3 following this introduction will respectively examine the ideological foundation of Islam and its implications for the economic behaviour of the individual in order to justify the need for Islamic banking by Muslims. Sections 4 and 5 will discuss the prohibition of *riba* and its economic rationalizations respectively. The Islamic alternatives to *riba* will be examined in Section 6.

2.2 Ideological Foundation

An economic system may be defined as the sum total of devices (or institutions and patterns of behaviour) which through their interaction give effect to economic choice. These economic devices are based on a set of law which embodies the philo-

sophical outlook, traditions, intellectual orientation or sometimes the distribution of political power in the society from which this law has emerged and to which it applies. Joan Robinson¹ in her *Economic Philosophy* writes, “Any economic system requires a set of rules, an ideology to justify them, and a conscience in the individual which makes him strive to carry them out.”

The influence of ideologies on the development of economic systems of the world today cannot be denied. As a systematic set of beliefs, opinion and doctrines about the political and economic phenomena of society, an ideology provides the basis for action and the framework of reference for groups of individuals or nations who believe in it. Hence a nation that upholds the ideology of *laissez-faire* capitalism would show a strong preference for free enterprise, private property and minimum state intervention in the economic sphere. Conversely, a society that believes in the communist ideology would emphasize the importance of public property, central planning and state enterprise. Similar to the other economic systems, the economic system of Islam is also rooted in certain “ideological ” foundations which apply to a society whose members choose Islam as their way of life. This is asserted by a Muslim economist, Abu Saud² who writes, “there is no “Islamic Economics” *per se* unless there is an Islamic ideology prevailing and applied in a Muslim community”; a note written in a similar vein to Mrs. Robinson’s above.

2.2.1 Source

At the outset, the ideological foundations of the Islamic economic system is not the product of philosophical inspiration from sources within the society, but originate from *Allah*, a divine source outside the society itself, and have been revealed

¹ 1963:13.

² 1980:59.

in the form of the *Quran* or The Holy Book and the *Sunnah* or the traditions of the Prophet Muhammad (peace be upon him). These two sources form the chief sources of Islamic law known as the *Shariah* from which the economic principles for the Muslim society are also derived. Because of their exogenous nature, the economic principles in these two major sources are constant and permanent in nature. They are not subject to change either in time or space and are therefore applicable to all Muslim societies at any age and at any level of economic development.

Besides the above two main sources, the ideological foundations of the Islamic economic system are also derived from the exercise of reason and logic or *ijtihad*.³ *Ijtihad* involves the process of rethinking, reinterpretation and also analogical deductions by reasoning of the principles and injunctions in the *Quran* and the *Sunnah*. It deals with a question of the *Shariah* that emerges in society from time to time either in the form of new social or moral problems that require solutions which have not been clearly defined in the two chief sources of the *Shariah*.

Ijtihad, therefore, forms a vital instrument that provides flexibility and dynamism into the Islamic economic system. It allows the Muslim community to deal with the economic problems of their time and exercise their judgement in providing solutions which are relevant to their current circumstances without deviating from the permanent principles in the *Quran* and the *Sunnah*. A well-known example of *ijtihad* in Islamic history is the judgement passed by Umar Al-Khattab (the second Caliph) during the year of the famine, that no thief's hand should be amputated when there is the slightest doubt that the crime was committed because of hunger and not of greed. In this example the exercise of *ijtihad* had

³ The main branches of *ijtihad* are *qiyas* (analogy), *ijma'* (consensus) and *istihsan* (deviation from *qiyas* on the basis of public interest).

amounted to the suspension of a clearly defined penalty for theft⁴ for the sake of public interest or *maslaha* which was more overriding in view of the prevailing circumstances at that time.

Hence, by virtue of its source the Islamic economic system is constant yet flexible at the same time. Its structure is not rigid but is bound to change, by the exercise of *ijtihad*, with the dynamic change in economic environment. Its basic principles, however, remain constant in conformity to the permanent principles laid down in the *Quran* and the *Sunnah*.

2.2.2 Philosophy

The economic doctrine of Islam is closely related to and is part of the Islamic concept of life. Islam in its very essence is the complete submission to the will of Allah and this submission is to be reflected in the life of the Muslim (one who submits) not only in his spiritual relationship with Allah but also in his relationships with his fellow-beings and nature. Based on this concept of complete submission, Islam is regarded by the Muslim not just as a religion in the restricted sense but also as a complete way of life. Hence within the overall Islamic system exist a number of subsystems - for example the Islamic economic system, the Islamic political system, the Islamic educational system - with specific functions to perform, but are yet interconnected and regulated by the *Shariah*.

Islam is also an integrated way of life because all aspects of life are interwoven by a network of principles and values. A single value is applicable not only to a certain aspect of life but is relevant to a whole range of disciplines. There is no dichotomy between secular and religious values in Islam. In the Islamic viewpoint,

⁴ Quran 5:41.

the struggle for economic well-being which conforms to the moral values in the *Shariah* constitutes an act of virtue and the economic activity performed assumes an act of worship or *ibadah*. Such rationality is of course completely alien and perhaps unacceptable in the conventional economic system. This is not unusual because an understanding of the Islamic economic system cannot be gained until the ideological bases of the system embodied in the Islamic worldview are fully revealed.

It must be admitted that the task of elaborating the Islamic worldview will entail a discussion of the vast matrix of concepts, principles and ethical values found in the *Quran* and the *Sunnah*; which lies beyond the limitations of this study. However, as all these concepts are derived or linked to the fundamental concept of *Tawhid* or the oneness and the sovereignty of *Allah*, our discussion will focus on this principle and its immediate corollaries.

2.2.2.1 Tawhid

Tawhid is the key concept which forms the basis of the Islamic faith. It signifies a complete submission of a Muslim to only one god and his rejection of other sources of value. There are two sides to the process of *Tawhid*. Firstly the total submission of man to *Allah* alone implies the uniqueness of His attributes. It negates the existence of other creators worthy of worship and confirms that all other beings have to be different from Allah in every respect. As noted by Al-Habshi⁵;

The oneness or tawhid is not only confined to number but also implies the oneness or uniqueness in all His sublime qualities or attributes. All other beings have to be different from Allah in every respect. In its simplest form the difference can be in terms of degree. For example,

⁵ 1991:42.

if one is rich, others are richer but Allah is the richest. ... This uniqueness in qualities makes it easier for us to logically accept His complete independence from others and that He provides for all and that all His creations depend upon Him.

The other side of *Tawhid* constitutes the rejection of all other sources of values, except Allah. It signifies the emancipation and the restoration of man's essential freedom from all human or (man-made) super-human bondages⁶. Unless this consciousness of man's freedom and independence is recognized, genuine *Tawhid* is not conceivable. As clearly expressed by Siddiqi;

Tawhid presupposes a consciousness in man of his stature independent of all being and dependent on the One Being alone. If this consciousness of independence and freedom is lacking, genuine *Tawhid* is impossible, and if it is deficient and vague, the relationship with Allah will be impure, weak and largely ineffective.

The significance of *Tawhid* in the life of a Muslim has an important implication on his behaviour with his fellow beings. With every man sharing the same relationship of complete submission to only one god a definite relationship between man and man is therefore clear.

Firstly *Tawhid* gives the Muslims the sense of being free and being equal to other man. It means that while all men are equally dependent on *Allah* they are equally free and independent of one another. Thus in the overall Islamic system where *Tawhid* is genuine no subordinate relationships amongst men should exist. A man will not fear another man more than Allah or behave as if Allah does not exist.⁷. As the Muslim's relationship with Allah is one of love and obedience, com-

⁶ Siddiqi 1989:2.

⁷ Abu Sulayman 1976:14.

plete trust and active service, the same kind of mutual bond will undoubtedly be nourished at the human level. Hence in the economic field, the behaviour of the Muslim cannot be devoid of honesty, goodwill, compassion and social consciousness. Because of this sense of brotherhood, the individual Muslim in seeking his own interest is not indifferent towards the interest of others.

2.3 Implications on Economic Behaviour

2.3.1 Trusteeship and Freedom

According to the *Quran*, *Allah* has created man as the best of His creation⁸ and has sent him to earth on the mission of trustee on earth or *Khalifah* for a limited term of life as a test.⁹ As His agent or trustee on earth, man has been delegated the power to utilize the abundant resources of the universe which has been made subservient to him. At the same time he is endowed with intelligence and the sense of justice and discretion. While he is given the freedom to explore and exploit the abundant resources, he is also urged by his creator to comply to an economic order according to his will as outlined in the *Shariah*. This compliance is guided by a set of ethical values which acts as constraints on economic activities to ensure that these activities do not contradict with the objective of achieving an equilibrium between personal spiritual ascension and the material well-being of the individual and society as a whole. The maximum and minimum limits of human behaviour are set by a clear-cut boundary of values (*hudud Allah*) in the *Shariah*. All actions outside this boundary are forbidden but within those limits man is free to use his intellectual and physical potentials to improve his life and society. Hence the concept of freedom in Islam is relative. Whilst only God is

⁸ We have indeed created man in the best of moulds (Quran 125:4).

⁹ Then We made you viceroys on earth to see how you behave (Quran 10:14).

absolutely free, man is also relatively free within the limits set by His creator.

An important implication derived from this principle of relative freedom is the concept of ownership in Islam. At the outset, based on the first aspect of *Tawhid* which signifies Allah as the only creator and provider, absolute ownership of all resources in the universe must therefore lie only in the hands of *Allah*. Man as the *khalifah* is just a trustee of the God-given resources.

Within the terms of this trusteeship, the acquisition of wealth in Islam is regarded not as an end but as a means to translate the submission to *Allah* or *tawhid* into actions. The concept of private ownership in Islam is therefore distinguished from the concept of private property of other economic systems.¹⁰

1. The acquisition of wealth is permitted through lawful economic pursuits mainly as a result of work and effort and not through unjustified means.¹¹
2. The right to private ownership is justified by its utilization. Hence in Islam land belongs to the man who tills it.¹² On the other hand, idle wealth decreases by the imposition of *zakat* or in the case of uncultivated land the right of ownership can be withdrawn by the state and transferred to others who are willing to utilize it. This is to ensure that the resources are for the benefit of all and not concentrated in the hands of a few.¹³
3. The utilization of the resources so acquired is directed to beneficial and

¹⁰ M.A Mannan (1985:65-73) has outlined eight basic rules governing the concept of private ownership in Islam.

¹¹ Do not acquire wealth from each other wrongfully, nor knowingly offer it to officials with the objective of unjustly acquiring the wealth of others (Quran 2:188).

¹² The Prophet(peace be upon him)is reported to have said, "Whoever cultivates the land which is not the property of anyone has a better title to it." (Bukhari).

¹³ In order that it (wealth) may not (merely) make a circuit between the wealthy among you. (Quran 59:7).

balanced use. Since the resources are given to man as a trust they must be utilized in activities that would yield benefit not only to one's own self but also to society. Private ownership of wealth therefore does not permit extravagance or frugality in its use.¹⁴ The acts of selfishness on the one hand negates the terms of trusteeship whilst the wastage of God-given resources is equated to the spreading of mischief (*fasad*) which also violates the position of trustee endowed to man.

2.3.2 Accountability

Closely related to the above concept of freedom in Islam is the concept of accountability. It is based on the simple logic that while man is given the freedom to act on his own freewill, God has sent (i) the Revealed Books as sources of guidance for man to remain within the maximum and minimum boundaries set by His will; and (ii) the prophets as His messengers who carried out His command on earth setting the examples for men to follow. Hence "once God has shown the right way" and bestowed man with intelligence and the sense of discretion, every person has the freedom either to submit or to deny His will. Nevertheless this freedom is counterbalanced by responsibility whereby every person is deemed to be accountable for his actions.¹⁵

This concept of man being made responsible for his actions is closely related to the Muslim's firm belief in the Day of Judgement and the existence of life after death. Muslims believe that the life-span of every individual is divided into this temporary life on earth and the eternal life in the hereafter. The destiny of his

¹⁴ Make not thy hand tied like a niggard's to thy neck nor stretch it forth to its utmost reach, so that those become blameworthy and destitute.

¹⁵ Every soul is a pledge for its own deeds (Quran 73:380).

life in the hereafter will depend on his deeds on earth for which he will be justly rewarded and at the same time be made accountable for his transgression of the limits set by the *Shariah* .

At the individual level, accountability tempers the non-altruistic animal instincts inherent in man. For example, it is possible for man to go to the extreme in the economic field and resort to unscrupulous practices in the form of usury, bribery, profiteering and exploitation inflicting injustice to others in the pursuit of material gain. Accountability therefore acts as a moral restraint to prevent the individual from exploiting others to satisfy his self interest. It allows man the economic freedom to the extent of stimulating private initiative but ensures that this economic freedom is not abused or detrimental to the promotion of justice in the market.

It therefore follows that the Muslim view of success includes success in both worlds. In the Islamic terminology, the ultimate aim in life which every Muslim wish to accomplish is *al-falah*, that is success in terms of the blessings of *Allah* both in this world and the hereafter. Expressed in the modern economic jargon, when the Muslim compares the benefits and costs of any choice of economic action he will have to consider the present value of all future outcome. The future outcome is measured, not only in terms of monetary gains and losses but also in the form of spiritual rewards or retribution in the life hereafter. This concept of success is meaningful only to the Muslim and does not make sense to either the capitalist economic man or the Marxian proletariat whose measurement of success is confined to the material gains only.

2.3.3 Economic Behaviour of the Islamic Man

The economic behaviour of the economic agent in the Islamic economic system must therefore conform to that expected of *Allah's* trustee on earth. The basic economic problem that he faces is viewed from an entirely different angle and therefore warrants entirely different solutions compared to those in the capitalist and communist economies.

In the capitalist economic system, the basic economic problem faced by the economic man is the relative scarcity of resources which are limited to satisfy the endless succession of his unlimited wants. Lionell Robbins¹⁶ defined economics as, "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses." As observed by Ariff¹⁷ Robbins perfected the concept of the rational economic man as "a self-seeking individualist and who will maximise ruthlessly to get what he wants". The economic man is conceived to be devoid of any ethical values. He is not concerned with value-judgements and remains neutral between different ends. What he is most concerned with is choosing the most efficient means in pursuing any end, whatever it may be, in a consistent manner.

The Islamic man on the other hand views the basic economic problem of relative scarcity from a different perspective. As mentioned earlier, *Allah* has created the whole universe and its contents in abundance to meet the multifarious needs of man. It is stated in the *Quran* (14:34);

And He (Allah) gives you of all that you ask for, and if you count Allah's favours, never will

¹⁶ 1932:16.

¹⁷ 1989a:96.

you be able to number them. Verily man is given up to injustice and ingratitude.

This verse obviously shows that to the Islamic man the problem of relative scarcity that arises in economics is not the result of insufficiency of natural resources relative to his unlimited wants. The estimate of God's unlimited bounties is constrained by man's limited wisdom that many substitutes to the present resources under man's use remain unknown until they are explored with the advance of human knowledge. According to Ariff¹⁸ 'where human efforts are called for to bring certain goods into existence, the problem of scarcity arises owing to the fact that the capacity of man is limited. The *Quranic* explanation that *man can have nothing but what he strives for*¹⁹ throws considerable light on this issue." In the case of goods already in existence, Ariff adds that the problem of "material shortages, economic misery and social suffering arise out of man's mismanagement of God-given bounties."

It can therefore be concluded that the problem of relative scarcity, from the Islamic viewpoint, is not the result of insufficient natural resources but is due to the limitation of man's physical and mental capabilities in exploiting the unknown resources of the universe. In other cases, the problem of relative scarcity is purposely created through hoarding and monopoly out of self-interest in the pursuit of material success.

Since the basic economic problem is viewed differently by the Muslim in the Islamic economy the next relevant question that arises is whether the economic agent is neutral between ends like the economic man. The endless succession of man's want is recognized in Islam as a God-given instinct. It is mentioned by the

¹⁸ op cit:105.

¹⁹ Quran 53:39.

Prophet (peace be upon him) in one of his traditions that:

If the son of Adam (man) had a valley of gold , he would want a second valley and if he had a second valley he would want a third. Nothing satisfies man's want until he is returned to dust.

However *Allah* has cautioned that this natural instinct of unlimited wants has been endowed to man not as an end by itself but only as a means to the ultimate end of complete submission to the will of *Allah* and to procure His blessings. The satisfaction of man's want must therefore conform to the values of Islam as prescribed in the *Shariah*. The economic behaviour of the Muslim community can only be adequately explained with reference to the Islamic ethics which govern it. It is this 'ethical factor' which differentiates the Islamic man (and hence the Islamic economic system), from the economic man in the capitalist system. As pointed out by Ariff²⁰, "The Islamic man draws upon his moral resources and acts in accordance with ultimate ethical values, whereas the economic man indulges in his preferences motivated by self-interest." This, however, does not mean that the Islamic man is less rational than the economic man. The economic behaviour of an individual is rational if he conforms to the behavioural pattern of his community. In this sense the Islamic man is rational because his economic behaviour is consistent with "the Islamic perception of human existence and mission in life."²¹

All this shows that the Muslim cannot remain indifferent between ends in his economic pursuits. This is in conformity with the Islamic principle that *Allah* has created the earth and the whole universe "*for just ends*".

²⁰ op cit:98.

²¹ ibid:98.

And We created not the heavens, the earth and all between them , but for just ends. (Quran 15:85)

In view of this verse it is necessary for the Muslim to recognize the consequences of his economic decisions. Just ends are those which are permissible in the *Shariah* and those which conform to the ethical values in the *Quran* and the *Sunnah*. Unjust ends are those which *Allah* have prohibited in order to ward off injustice, damage or exploitation.

Here again it is apparent why the framework of the Islamic economic system is value-laden. Just ends themselves being ethical in nature cannot be achieved through unjust means. In the economic field, all individual business transactions require a high degree of honesty and fairness. Cheating, usury, bribe, fraud and similar unscrupulous practices are unjust acts which hinder the achievement of just ends. For the Islamic economic system as a whole the supply of goods and services in the market must be consistent with the ethical boundaries of consumption, production and distribution in Islam.

The *Shariah* has prescribed the consumption of good and pure things which *Allah* has made lawful or *halal* and the avoidance of bads which He has made unlawful or *haram*. The lawful goods have been created by *Allah* as a means of sustenance in the process of submission to Him while the unlawful things have been created as a test to man. In this context, the manufacture and sale of these Islamically prohibited goods may be profitable economic activities in the capitalist economy but not so in the Islamic economy where the demand for such goods is non-existent. Even the demand for the lawful goods is constrained not only by income but also by the Islamic principle of moderation (*iqtisad*) and the avoidance

of extravagance (*israf*). Thus, according to Mannan²², “it is possible to conceive that in a properly run Islamic community a consumer may refuse to buy “more of a good ”, when prices are falling or incomes rising, when he thinks that he is exceeding the limits of “moderation” as prescribed by the *Shariah*.

In conclusion neither the consumer nor the producer is sovereign in the Islamic economy. Utility-maximizing behaviour is directed only towards the achievement of just ends. It is constrained not only by the feasibility-possibility frontier but also by the ethical allowability constraints of the *Shariah*.²³

2.3.4 Distributive Justice

Whilst relative economic freedom implies the promotion of justice in the market, the promotion of social justice from the aspect of distribution is the central function of the fiscal system of the Islamic state.

In principle, Islam recognizes the inequality of income in society because all men are not equal in their physical and mental abilities; and wealth. The Quran states;

He has raised you in ranks, some above others: that He may try you in the gifts He hath given you. (2:165)

Allah has bestowed His gifts of sustenance more freely on some of you than on others (16:71)

Although the inequality in the distribution of income and wealth is acceptable in Islam on the basis of the above differences, the Islamic economic system is still

²² 1985:10.

²³ Al-Habshi 1991:45.

required to attain social justice by ensuring that every member of the society is not deprived of his basic needs. If the basic needs of certain individuals to live as a human being cannot be achieved in the market then the obligation to ensure distributive justice becomes the responsibility of the immediate society under the supervision of the State.

The most effective social security system which the state can employ is the institution of *zakat*; an obligatory tax on wealth that shifts resources from where they can be easily spared by the haves to where they are urgently needed by the have-nots. No sector of the economy is excluded from *zakat*. *Zakat* is taxed on all productive properties, agricultural produce, capital, savings and other forms of hoarded wealth that reach the taxable minimum (*nisab*). The beneficiaries of *zakat* are also explicitly defined in the *Quran*. *Zakat* proceeds can only be distributed to the poor, the indigent, the collectors, the new converts, the emancipation of slaves, the debtors, the way of *Allah* and the wayfarers; hence ensuring that the revenue will not flow back to the payers.

Through *zakat* distributive justice is achieved by equitable distribution and not equal distribution. The basic needs of the poor are met but private initiative amongst wealth holders is not deterred. Since *zakat* is imposed on surplus wealth it is often viewed as a penalty which will induce the holders of idle capital to put these resources into productive use in order to avoid further depletion by *zakat*.

In summary the Islamic economic system paves a middle course for man to carry out his economic activities. The freedom of individual enterprise is guided by ethical restraints to remove the impediments to economic and social justice. One of the ways in the *Shariah* to eliminate these obstructions is by their prohibition.

In the context of finance and banking the prohibition of *riba* is a key factor. In the Islamic viewpoint, the taking or giving of *riba* is not justified and its prohibition is fundamental for the establishment of economic and social justice from the Islamic perspective.

2.4 The Prohibition of Riba

One of the essential requirements of Islamic banking is the complete elimination of *riba* from all banking transactions and operations. On the assumption that the term *riba* includes interest, the direct implication of this rule is that interest which forms the backbone of modern banking has no role in the Islamic banking system. Yet one school of thought²⁴ believes that *riba* is distinguishable from interest and that Islam has forbidden only *riba*, not interest. In view of such controversy the following sections will examine some of the major issues surrounding the prohibition of *riba* in Islam beginning with an inquiry into its meaning and forms.

2.4.1 The Meaning of Riba

The term *riba* in Arabic literally means increase, expansion or growth. However this linguistic meaning is not sufficient to denote accurately the kind of increase prohibited because not all financial increases are forbidden in Islam. As an example, the increase that accrues from trade is highly recommended. As translated from the *Quran*

Allah has permitted trade and forbidden *riba* (2:275-279)

In the *Shariah*, *riba* technically refers to the 'premium' that must be paid by

²⁴ Sheikh Jawish 1908, Fazlur Rahman 1964.

the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.²⁵

Three elements of *riba* can be derived from the above definition.

1. an excess or surplus over and above the amount lent
2. determination of this excess in relation to time
3. the surplus is predetermined or fixed in advance

All three elements jointly constitute *riba*.

It has been suggested that in order to recognize the nature of *riba* which is forbidden in Islam one has to understand the meaning of *riba* in its historical perspective²⁶. This is based on the argument that the Pre-Islamic Arabs were familiar with the word *riba* and knew its customary connotation when the injunctions against *riba* were revealed. The practice of lending with *riba* was well established among the Arabs and between the Arabs and the Jews who were residing in the Arab Peninsula at the time of the revelation of the *Quran*²⁷. The use of the definite article “*al*” (the) before the word *riba* in the *Quran* is therefore indicative of the customary practice.

2.4.2 The Forms of Riba

Broadly, *riba* can be divided into two categories namely:-

- (i) *Riba* on loans (*riba al-duyun*)

²⁵ Chapra 1985:56-57.

²⁶ Mannan 1985:118.

²⁷ Homoud 1985:20.

(ii) *Riba* in barter trade (*riba al-buyu*)

2.4.2.1 Riba on Loans

Generally, *Riba* on loans refers to any fixed increase charged by a creditor to a debtor, over and above the principal amount of loan due. Specifically, early Muslim scholars who researched the kinds of *riba* prohibited in Islam, had described different forms of loan transactions involving *riba* such as

- *Riba al-jahiliyyah* or *riba* of the Pre-Islamic period, which was well-known and conventional among the Arabs before Islam. According to Mujahid, “*riba* of the *Jahiliyyah*, which God has forbidden, was that if a person owed a loan he would say to the creditor, ‘I will give you so much if you extend the date for payment’”. Another kind of *riba* in the *Jahiliyyah* was reported by Imam Razi who said that the people of the *Jahiliyyah* used to give loans and collect *riba* monthly without affecting the principal. Then, when the loan matured, the principal amount was demanded and if the borrower was unable to meet his obligation, the amount was increased and the payment period was extended.
- *Riba al-nasi’ah*, which was the fixing in advance of a positive return on a loan as a reward for waiting. The term *nasi’ah* is derived from the root *nasa’a* which means to postpone, defer or wait.²⁸

During the Pre-Islamic period *riba al-nasi’ah* was realized when a person gave a loan for a specified period and if the debtor was unable to pay the principal sum, the creditor would extend the payment period on condition that the debtor would pay a predetermined additional amount. In this case *Riba* was charged by

²⁸ Chapra 1985:57.

the creditor more or less as a reward for waiting a longer period before the debt was paid.

- *Riba al-qurud* which was derived from the term *Qard* or loan. This kind of *riba* was earned when a loan was given on the agreement that after a specified period of time, the borrower would pay an additional amount together with the principal sum due. It differed from *riba al-jahiliyyah* since it was charged at the very beginning of the loan period. Additional *riba* would be charged if the borrower failed to clear what was due from him. This form of *riba* closely resembles the modern practice of fixing interest.

At this point it can be deduced that any kind of loan transaction which involves a predetermined addition to the amount of principal due constitutes *Riba* on loans which is not permitted by the *Shariah*. It is the *predetermined positiveness* of the return which constitutes the important element of *riba*.²⁹ It does not matter whether the addition is a fixed or variable percentage of the principal, paid in advance or on maturity, or is paid in kind or service.

2.4.2.2 Riba in Barter Trade

Riba in barter transactions or *riba al-buyu* is prohibited when certain commodities are exchanged in unequal quantities or when certain goods are exchanged on deferred delivery. The injunctions against *riba al-buyu* were given in the *Hadiths* (sayings) of the Prophet, of which the following two are considered most important.

- From Ubada Ibnus-Samit, the Prophet said:

Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt

²⁹ Chapra *ibid*.

for salt — like for like, equal for equal, and hand to hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand to hand (Sahih Muslim)

- From Abu Said al-Khudri, the Prophet said:

Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt—like for like, and hand-to-hand. Whoever pays more or takes more has indulged in *riba*. The giver and the taker are alike (in guilt) . (Sahih Muslim)

On the basis of these two *Hadiths*, two types of *riba al-buyu* can be distinguished.

1. *Riba al-fadl* which arises when items of the same kind (as mentioned in the *Hadiths*) are exchanged with an increase in weight of one over the other. As an example, the spot exchange of one kilo of wheat for two kilos of wheat would involve *riba al-fadl* even if there is a difference in quality between the two items.
2. *Riba al-nasa'a* which occurs when one of the six items in the *Hadiths* is exchanged for an item of its own kind or for one which is similar to it in value, on deferred delivery. This statement needs further elaboration. Muslim scholars have divided the six items in the above *Hadiths* into two different classes of goods. Gold and silver were classified together in terms of their value as precious metals while the remaining four items were defined as fungible commodities. Hence in the case of *riba al-nasa'a* the exchange of gold for silver on deferred delivery is forbidden. Similarly the exchange of dates for barley must take place on a spot basis to avoid *riba al-nasa'a*. The exchange of gold for wheat is permitted, however, because the transaction is not subjected to any of the above requirements since both differ in kind or in value.

The conditions for *riba*-free barter transactions is summarized in Table 2.1. The conditions against *riba al-buyu* requires that:

- In the exchange of precious metals or fungibles of the same type (e.g silver for silver or wheat for wheat), (i) equality in weight like for like, equal for equal and (ii) prompt delivery hand to hand must be observed.

Failure to meet the first condition will lead to *riba al-fadl*, while the absence of the second requirement will cause *riba al-nasa'a*.

- In the exchange of precious metals or fungibles respectively (e.g gold for silver or dates for barley) only the condition of spot delivery is required.

Table 2.1 — Conditions For Riba-Free Barter Trade

		Precious Metals		Fungible Goods			
		Gold	Silver	Wheat	Barley	Dates	Salt
Precious Metals	Gold	ES	S	—	—	—	—
	Silver	S	ES	—	—	—	—
Fungible Goods	Wheat	—	—	ES	S	S	S
	Barley	—	—	S	ES	S	S
	Dates	—	—	S	S	ES	S
	Salt	—	—	S	S	S	ES

Source: Shallah 1989:71

Key:

ES = equal weights and spot exchange

S = spot exchange

-- = none of above conditions required

- In the exchange of precious metals for any one of the fungible commodities in the *Hadiths* any form of barter exchange is permitted. A transaction is fulfilled

if wheat is exchanged for silver, for example, either with equal or unequal quantities or on spot or forward delivery.

Muslim scholars³⁰ have regarded the prohibition of *riba* in barter trade as a step towards the monetization of the economy because the Prophet is reported to have encouraged the use of money in order to avoid *riba*. When one of his companions had exchanged two measures of low quality dates for one measure of good quality dates the Prophet had warned them:

This is exactly *riba*. Do not do so, but when you wish to buy, sell the inferior dates for money and then buy the dates. (Sahih Muslim)

The use of money in exchange as encouraged by the Prophet is meant to overcome the difficulty of estimating equivalence in barter exchange.

Finally, there is disagreement among Muslim jurists as to whether *riba al-buyu* affects only the six commodities mentioned in the *Hadiths* or whether some general principles cover a whole class of commodities³¹. This is a legal issue which lies outside the scope of Islamic banking.

From the above discussion on the types of *riba* prohibited in Islam it can be inferred that whilst the occurrence of *riba* in barter trade can rarely be found in today's monetized economy the rate of interest charged by the conventional banks seems to contain the elements of *riba* on loans. The question that arises is whether interest constitutes an element of *riba* which is forbidden in Islam.

³⁰ Siddiqi 1983, el-Ashker 1988.

³¹ Homoud 1985:87.

2.4.3 Riba, Interest and Usury

Historically, all returns derived from the lending of capital was originally known as usury in the west and it carried no ethical connotation. However, as the abuse in moneylending became significant in the late Middle Ages where excessive rates of usury were charged by moneylenders, the distinction between interest and usury became necessary. The term 'interest' ; derived from the Roman word *interesse* or interval was adopted; to specify an indemnation for damage due to the delay in the interval *interesse* before repayment.³² Since then interest became distinguishable from usury; the former tolerated by canonical and civil courts as legal and the later narrowed down to refer only to excessive loan charges which are iniquitous or illegal.³³

There is no distinction between usury and interest in Islam, however. Both are elements of *riba* because of the *predetermined positiveness of a return* inherent in both. Even though the *Quran* states,

Oh you believers, take not doubled and redoubled *riba*, and fear Allah; so that you may really succeed. (Surat aali-Imran; 3:130)

the above verse should be interpreted, not in isolation but in the context of the other verses pertaining to the prohibition of *riba*.

Two significant points can be observed in relation to the prohibition of *riba* on loans. Firstly, most of the injunctions pertaining to *riba* on loans were revealed in the *Quran* in contrast to those regarding *riba* on barter trade which were all recorded in the *Sunnah*. Secondly, the enforcement of this injunction took place

³² Knight 1932:131

³³ Salin 1932:194.

gradually in several stages; in correspondence to the period of transition of the Arab community; from the *Jahiliyyah* (Era of Ignorance) to the establishment of the Islamic State when Islam was embraced and practised as a complete system of life. The course of time was indeed necessary for the people to believe in Islam first before the prohibition of a deeply embedded institution in the society, such as *riba* could be easily obeyed. An instant prohibition could have been difficult if not impossible.

The prohibition of *riba* in the Quran underwent four stages of revelation.

1. The initial stage (of encouragement):

The first verse against *riba* was revealed in Makkah before *Hijrah*.

And whatever you give (as *riba*) to increase your wealth increases not with Allah, but whatever you give in charity, seeking the pleasure of Allah will be compensated manifold. (Surat al-Rum; 30:39)

In their interpretation of this verse most commentators agree that *riba* here refers to a gift or donation given with the hope of receiving a better gift in return³⁴ However it appears here that *riba* was not strictly prohibited, it was only discouraged. Instead the people were encouraged to give donations purely for the sake of *Allah* seeking a better reward from Him in the hereafter. At that early stage of Islam the *Quran* was merely preparing the souls of the people for Islam and instil the unity of *Allah* in their hearts. This preparation was made through the comparison between *riba* and charity by saying that those who seek reward in the hereafter by giving donations are better than those who seek reward in this life by increasing their wealth through *riba*.

³⁴ Qutb 1980, Homoud 1985.

2. The stage of indirect warning:

And for their taking *riba* even though it was forbidden for them, and their wrongful appropriation of other peoples' property, We have prepared for those among them who reject faith a grievous punishment. (Surat al-Nisa'; 4:160-161).

The meaning of this verse cannot be understood unless it is placed in the historical context in which it was set. At the time when this verse was revealed the Jews were charging *riba* on loans to everybody except among themselves. This practice was claimed to be in accordance to their interpretation of the Bible which cites:

Deuteronomy: Verse 23:19-20

Thou shalt not lend upon usury to thy brother, usury of money, usury of virtuals, usury of anything that is lent upon usury. Unto a stranger thou may lend upon usury, but unto a brother thou shalt not lend upon usury.

Muslim scholars however pointed out that there is another verse in the Bible which forbids usury in all circumstances.³⁵

He who hath given forth upon usury, neither hath taken any increasehath executed true judgement between man and man.

The phrase 'man and man' in this verse clearly emphasizes that usury was forbidden to everyone. Hence by using the misinterpretation of the Jews as an example, the *Quran* clarifies that Allah has already forbidden *riba* in His earlier Book, the Bible, and the grave consequences for the Jews who violated the rule.

³⁵ Homoud 1985.

3. The stage of direct but incomplete prohibition:

Oh you believers, take not doubled and redoubled *riba*, and fear Allah; so that you may really succeed (Surat aali-Imran; 3:130)

This verse was revealed at Madinah in the third year after *Hijrah* and was directed to the believers (Muslims). Interpreters are agreed that only multiple *riba* was forbidden at this stage. Those who continue to charge low rates of interest were allowed to do so. However the revelation against *riba* did not stop here.

4. The stage of absolute prohibition

Those who benefit from *riba* shall be raised like those who have been driven to madness by the devil's touch. This is because they say: Trade is just like *riba* while Allah has permitted trade and forbidden *riba*..... Oh believers, fear Allah, and give up the *riba* that remains outstanding if you are believers. But if you do not do so, then be sure of being at war with Allah and His Messenger. But if you repent, you can have your capital sum. Neither should you commit injustice nor should you be subjected to it. (Surat al-Baqarah; 2:275—279)

These final verses on *riba* provide a comprehensive and unambiguous ban upon all predetermined surplus on loans including all rates of interest no matter how high or low. This conclusion is based on the following arguments.

(i) The phrase Allah has permitted trade and forbidden *riba* is an indirect indication that all rates of interest is forbidden. As no limitation is set on the prohibition, in contrast to that at the third stage, it necessarily means that all rates of predetermined excess, including low rates of interest are forbidden. It is, therefore, a misconception if one says that Islam prohibits only usury or compound interest and allows the simple interest. With reference to the verse at the third stage of

prohibition, it is true that only the prohibition of compound interest or usury is explicitly forbidden. However, one should also take into account other conditions in the *Shariah* before passing a judgement on the interpretation of the ruling in the *Quran*. An important condition in Islamic law methodology (*usul al-fiqh*) states that a rule or *naskh* which is revealed at a later stage will abrogate any previous rule on the same matter. Hence if one applies this condition in relation to the time period of each stage of prohibition, it would be clear that the rule which limits the prohibition of *riba* to usury no longer applies. With the revelation of lines 275 to lines 279 of *Surah al-Baqarah* at a later stage the rule in line 130 of *Surah aali-Imran* is annulled.

(ii) The second evidence which supports the argument that *riba* is not confined only to usury is contained in the text If you repent, you can have your capital sum. In this text it is shown that those who repent from taking *riba* is entitled to recover only the principal sum of loan given and not more. The term capital sum clearly defines that a lender can only demand payment for the capital sum lent and nothing more. Put in a different way, any payment which is demanded from the borrower which exceeds the capital sum amounts to *riba* even if the sum is insignificant.

(iii) It is further argued that the prohibition of *riba* which is limited only to usury can lead to arbitrariness. Qureshi (1946) posed the question, “what do they mean by usury(If usury)...is the lending of money at exorbitant rateswhat is an exorbitant rate of interest ?”. Qureshi further adds that a rate of interest which is considered moderate and reasonable today may be considered exorbitant and excessive tomorrow. For example, cooperative societies in the 1920s were charging interest with rates that ranged from 12 to 15% per annum. These rates were considered reasonable at that time but exorbitant today.

The arbitrariness between interest and usury is also evident in the financial system where different financial institutions can charge exorbitant rates of interest for similar type of loans. Mannan³⁶ writes, "In the U.S.A, for example, during the nineteen-fifties and sixties a bank could not charge more than eight per cent as interest whereas a finance company could charge thirty per cent to thirty six per cent of interest per annum for a similar loan".

Based on these observations both writers argue that it is a fallacy to distinguish between interest and usury where the question of the prohibition of *riba* is concerned. There is no real distinction between interest and usury. The difference that exist between both is a difference in terms of degree, not of kind and hence both are prohibited in Islam.

From the above arguments it can be concluded that (a) all predetermined surplus on loans including interest is prohibited in Islam and (b) all rates of interest, whether high or low, are also prohibited. As asserted in the report of the Council of Islamic Ideology in Pakistan 1981;

there is complete anonymity among all schools of thought in Islam that the term *riba* stands for interest in all types and forms.³⁷

2.5 The Economic Rationalization for the Prohibition of Riba

As can be seen in the previous section the restriction against *riba* is very clear and has to be taken as axiomatic. It is a divine order which no Muslim can reject, nor can the real reason of the order be fathomed by the limited human mind. Nonetheless, Muslim scholars have tried to analyse the possible reasons of this

³⁶ 1985:162.

³⁷ Ahmed et al 1981:111.

rule from various aspects. For the purpose of this study, the economic explanation behind the ban will be of interest.

The economic rationalization for the prohibition of *riba* can be viewed from three perspectives. It can be seen (i) in the light of the *Quran*, (ii) in terms of weaknesses in the theories of interest and (iii) in terms of the negative effects that interest inflicts on the economy.

2.5.1 The Quranic viewpoint—prevention of injustice

In the *Quran* the reason for the prohibition of *riba* is implied in the fourth stage.....neither should you commit injustice nor should you be subjected to it. One can gather from this text that the the prohibition of *riba* from the viewpoint of the *Quran* is directed towards the prevention of injustice, one of the principal objectives of the Islamic economic system. Injustice or *zulm* in Arabic is a comprehensive term which has a broad meaning. Literally *zulm* is understood as ‘putting something not in its rightful place’. As a noun it refers to any form of wrongdoing which is committed by man in his relationship with God, with himself and with other men. The *Quran* does not specifically address the reasons behind the prohibition of *riba* in the light of these three relationship. However since *riba* enters into the financial relationship between men, one may be able to rationalize the reasons behind its prohibition by considering Islam’s position on individual property rights and its concept of economic justice.

- In Islam, money represents the monetized claim of its owner to property rights created by assets obtained either through work or through exchange, grants or inheritance. Lending money is a transfer of this right and all that can be

claimed in return is its equivalent and not more.³⁸ In this context the payment of *riba* on loans can be considered as an illegitimate transfer of property rights from the borrower to the lender or vice versa. To illustrate, if interest is charged on money borrowed for consumption purposes a transfer of property rights from the borrower to the lender takes place even though no extra wealth has been created by the borrower. On the other hand, if funds are lent on the basis of a business loan and additional capital wealth is created by the borrower the payment of interest could account for an unjustified transfer of property rights in the opposite direction, that is, from the borrower to the lender. This is because the lender is entitled only to a small fraction (represented by the interest rate) of the wealth created from the use of his funds. A justified transfer of property rights would require that the lender is remunerated a percentage of the profits accrued and not a fixed percentage of the loan. The prohibition of *riba* eliminates the likelihood of such illegitimate transfers of property rights. It is an injustice in Islam when a person deprives others of their rights. The prohibition of *riba* therefore acts as a deterrent against such behaviour.

- In the context of economic justice, it is emphasized in the *Shariah* that the waiting involved in the repayment of a loan does not itself justify a positive reward.³⁹ This based on the Islamic argument that money is entitled to a reward only if it is put into productive use. In this sense, waiting is an unproductive activity and the payment of interest cannot be justified. Even if one is to argue that the reward for waiting represents an opportunity cost for a given investment, the payment of the fixed rate of interest is still not justified economically. This is because investment is often exposed to risks and

³⁸ Iqbal et al 1987:2

³⁹ Chapra 1985:57.

uncertainties that the final outcome can either be positive or negative. In the Islamic economic system any form of financial arrangement is allowed so long as the shares of each party involved are contingent upon uncertain gains. The element of uncertainty is crucial in establishing economic justice because it legitimizes the distribution of possible profits and also because neither party will be discriminated. The borrower-entrepreneur will not be forced to pay the lender out of his own pockets in the event of losses and the lender-financier will be remunerated to the extent of the productivity of his financial capital when profits are made.

From the above viewpoint, interest represents a source of unjustified earning since one party receives a monetary advantage without giving a just countervalue. Ethically, it represents a wrongful means of acquiring property which impedes the establishment of economic justice and fairness which is the main aim of the Islamic economic system.⁴⁰. Hence, in the light of the *Quran* the economic rationalization of the prohibition of *riba* lies in the promotion of economic justice and fairness which Islam continuously seeks. As noted earlier the fundamental aim of the Islamic economic system is to achieve “just ends”. The prohibition of *riba* is one of the means towards securing those ends.

2.5.2 Weaknesses in the Theories of Interest

The second perspective from which the economic rationalization of the prohibition of *riba* can be seen is in terms of weaknesses in the western theories of interest. The fundamental objection of Muslim writers to the western theories of interest relates to the fact that these theories have failed to provide a satisfactory

⁴⁰ Quran 2:188, 4:29, 4:161 and 9:34.

explanation to the question of why interest should be paid.⁴¹ It is argued that the existing theories of interest are merely attempts to validate the existence of an institution that has become deeply entrenched in modern economics rather than as attempts to justify on the basis of modern economic analysis, why the money lender should be rewarded a fixed return on the money he lends.⁴²

There is a wide difference of opinion among western economists regarding the economically-logical justifications for interest. Even if one does not consider the objections of Muslim writers the numerous western debates on the subject of interest is enough to support the view that there is no clear and categorical explanation for the existence of interest. Harberler in his *Prosperity and Depression* (1939) acknowledges that "the explanation and determination of the interest rate gives rise to more disagreement among economists than any other branch of economic theory." Some writers such as those who focus on the money market have found an ingenious way of avoiding the question of why interest is paid by shifting attention to how the rate of interest is determined. For the purpose of this section some of the theories of interest will be reviewed taking into account their weaknesses as seen mainly by the western writers. An excellent review of the early ideas of interest has been undertaken by Bohm Bawerk in his *Capital and Interest* (1922). Much of the critics against the early theories of interest in this study will therefore follow largely Bohm Bawerk summaries of those theories.

2.5.2.1 The Colourless or Classical Theories

The theories of interest propounded by the classical writers are called colourless theories by Bohm-Bawerk because in his observation Adam Smith has not laid

⁴¹ Uzair 1980, Mannan 1985.

⁴² Abbas, Mirakhor 1987.

down any distinct theory of interest and the following classical writers such as Ricardo, Torrens and McCulloch have based their ideas on those of Adam Smith's without adding much or enough to form definite theories of interest.

One of the main notions of these theories is the justification of interest via the existence of business profit. In these theories interest is regarded as a derivative of profit. According to Adam Smith profits consist of interest plus a risk premium. In such countries as Britain, he thinks about half of what is normally regarded as profits is pure interest on capital; the rest is payment for superintendence and risk.⁴³ In the typical classical firm in which the capitalist and the entrepreneur are the same person interest is hardly distinguishable from profit since the whole business capital is provided and accrues to the same individual. In the case where capital is borrowed, interest is treated as the compensation paid by the entrepreneur to the capitalist for the profit made by using the latter's capital. As asserted by Ricardo, "whenever a great deal can be made by the use of money, a great deal can be given for the use of it"⁴⁴

Schumpeter (1934) in his evaluation of the classical theory argues that the oversimplification of interest being derived from profits and that its rate is roughly determined and equal to that of profits is a fundamental flaw. The notion that interest is derived from profit raises the problem of discovering *why* such a derivation exists, and after having done so, one still needs to find out *how* interest arises from entrepreneurial profits. An adequate analysis must differentiate between interest and profits which according to Schumpeter the classical economists have failed to do.⁴⁵

⁴³ Blaug 1987:46.

⁴⁴ Mannan:121.

⁴⁵ Conard 1959:12-13.

From the Muslim writers' point of view the classical identification between interest and profit provides no explanation that relates fixed interest to variable rates of profits which may not always be positive⁴⁶. Mahmud Ahmad⁴⁷ had earlier argued that such an identification reveals the failure to delineate the different economic roles played by personal or undertaker capital and loan capital. It is asserted that personal capital is a variety of risk capital which can serve a productive effort on negative returns in contrast to loan capital which dictates its price of participation in the form of a fixed rate of interest. For this reason loan capital imposes a limit to the marginal efficiency of productive effort, while risk capital, on the other hand generates among entrepreneur the willingness to run risks on all kinds of productive enterprises. The use of the word "profit" for "interest" has not only failed to provide a logical explanation for the existence of interest in profits but also created a confusion on the essential nature of these two kinds of rewards.

The classical writers also justified interest as an inducement to save. It is envisaged that the sum saved out of a given income necessarily increases when the rate of interest is increased and vice-versa. However this argument is not necessarily true all the time. Keynes argued that savings do not depend so much on interest as on the level of income and employment. Savings and investment are determined more by income and other psychological factors rather than the rate of interest. This Keynesian argument is empirically supported by observations of increasing savings over periods when interest rates are falling.

2.5.2.2 The Abstinence Theory

This theory which attempts to rationalize the payment of interest from the

⁴⁶ Mannan:121.

⁴⁷ 1952:178-179.

supply side regards interest as a reward for abstinence from consumption on the part of the capitalist. Senior, the founder of this theory sees abstinence as the third independent factor of production besides labour and land. According to Senior, "the sacrifice which lies in the renunciation or the postponement of gratification demands compensation. The compensation is interest."⁴⁸

The abstinence theory has been ridiculed and rejected mainly because it implies positive discomfort in savings irrespective of differences in the level of abstinence among savers at different levels of income. Whilst it is true that saving involves sacrifice when income is low because many needs remain to be fulfilled, the act of saving for the average saver in the upper income brackets imposes the least pain or inconvenience. In fact personal savings for the upper income group is largely involuntary and is the result of income exceeding customary levels of expenditure. The question that follows is to what extent is interest a compensation for the differences in sacrifice between the different groups of savers. It is an irony if interest payments represent compensation for sacrifice when the low-income earners who have to forgo a large part of consumption are paid low interests for their small savings while the rich with large savings are paid exorbitant rates of interest when their sacrifice in abstinence is negligible.

Another doubtful notion of the abstinence theory is the idea that abstinence is an independent factor of production. Bohm-Bawerk notes that by nature a factor of production must be an entity which is capable of providing productive services and its reward should be related to its actual contribution to the ultimate produce. The payment for labour already includes payment for abstention from other activities and hence from this point of view interest payment is not justified.

⁴⁸ Bohm-Bawerk, 181.

2.5.2.3 The Productivity Theories

The advocates of this theory considers productivity as an inherent property of capital. They say that capital possesses the physical productivity because with its assistance more goods can be produced than without it. Critics such as Bohm-Bawerk do not deny the productivity of capital. However he argues that the productivity theories fail to show that productivity *per se* provides an adequate reason for the payment of interest.⁴⁹ One of the questions that needs to be explained is the problem of value. To explain interest by reference to productivity, Bawerk argues that it would be necessary to show that not only more goods are produced with the aid of capital, but also that the value of such goods is greater than the value of the former smaller output. Capital would presumably be of no value if it produces nothing and conversely be of much value if it produces valuable goods. The problem with interest is that it represents a predetermined surplus value which is not necessarily equal to the value of the ultimate good produced.

The objection of Muslim writers on the productivity theories of interest is based on the argument that the justification for interest is inadequate since it is derived from the concept of physical capital or capital goods. When the same justification is applied to money capital a confusion would arise.⁵⁰ For instance, the justification for the payment of consumption loans cannot be explained by the productivity theories.⁵¹

2.5.2.4 The Bohm-Bawerk or Agio Theory

Subsequent to his review of the early theories of interest Bohm-Bawerk pre-

⁴⁹ Conard:29.

⁵⁰ Uzair 1982:40.

⁵¹ Mannan:122.

sented what became known as the Agio or Austrian Theory of Interest. By this theory interest arises from a difference in value between present and future goods. Bohm-Bawerk believes that present goods are as a rule, worth more than future goods of the same type and number. Interest, therefore, is a premium obtained by present goods in exchange for future ones. This theory implies that the average person prefers present satisfaction to future satisfaction and if he is willing to forgo the present use of his funds, then he is entitled to some form of remuneration in the form of interest. Three reasons are listed by Bawerk as to why people prefer present over future:-

1. "the prospective underestimation of the future"
2. "the different circumstances of want and provision in the present and in the future"
3. "the technical superiority of present goods over future goods" .

The first reason is based on the assumption that people have a tendency towards myopia or they lack the 'telescopic faculty' because of factors such as lack of imagination, limited willpower and the shortness and uncertainties of life. As a result it is alleged that they value present consumption more than it will be in the future. Nevertheless, it is envisaged that there will be a willingness to forgo present consumption for future consumption if a premium in the form of interest can be offered. On the demand side, however, the prospective underestimation of the future will create an excess demand for consumption loans. The payment of interest on these loans is a discount which future satisfaction undergoes when judged from the present standpoint.

This assumption of inherent myopia has been rejected by a number of valid ar-

guments. Firstly, the assumption of deficiency of imagination and limited willpower cannot explain the desire to bequeath fortunes to heirs and save for rainy days. Blaug⁵² argues that “the loss of future enjoyment is feared quite as much as the loss of earning power and this leads to a discount on the present.” Hence in a modern society, most people discount the future as well as they discount the present. The assumption that people prefer present over future because of their underestimation of the future cannot therefore be generalized.

Blaug⁵³ pointed out that the appropriate assumption for a static theory of interest such as Bohm-Bawerk’s is that income stream would be constant over time. However, this assumption cannot explain the behaviour of people who are living below subsistence or who are expecting to be better off in the future; who will tend to prefer present over future goods and hence generating the demand for consumption loans at a positive rate of interest. The young who are acquiring their skills will have a high discount on the future but the old who have passed their peak earnings would probably discount the present in favour of the future. It is not clear which pattern of behaviour will be exhibited in a stationary economy unless the population distribution is assumed to be of uniform age, which is rather unrealistic. If a dynamic society is assumed where real income is rising through time, then the explanation for the emergence of a positive rate of interest can only be done if the dubious law of constant diminishing utility of income is assumed.

The third reason of “technical superiority of present over future goods” creates a demand for production loans because in the context of the *roundabout* methods of production, present goods can be invested now and reinvested as they accrue

⁵² 1987:503.

⁵³ op cit:500.

tomorrow compared to goods available tomorrow which can only be invested tomorrow.⁵⁴ In terms of physical product, it is claimed that present goods possess the technical superiority because they yield a larger physical output than an equal amount of goods applied to *roundabout* method of production in future because of the law of diminishing returns. Bohm-Bawerk believes that the net physical productivity alone creates a value discount on the future independent of time preference and the myopic tendency. However as Fisher and the others argue interest cannot be explained by the productivity of capital in the absence of time preference. It is said that if interest represents the payment borrowers are willing to make in order to have goods today instead of tomorrow, then interest is related to time preference.

The criticisms of the Austrian theory further support the Islamic contention that the existing theories of interest are not based on strong grounds hence fail to provide a realistic and concrete explanation for the payment of interest.

2.5.2.5 The Exploitation Theory

As proposed by Karl Marx, the exploitation theory, views interest as a surplus value which is a payment representing the difference between the value of capital goods and the value of the goods which these capital goods have helped to produce. According to the exponents of this theory "all goods that have value are the products of human labour. The workers, however, do not receive the entire product which they alone have produced. The capitalist exercises the control over the indispensable means of production which the institution of private property guarantees him, to secure for himself a part of the workers' product."⁵⁵ Interest is that

⁵⁴ Blaug *ibid* :504.

⁵⁵ Bohm-Bawerk:241.

portion of labour acquired by putting the labour under coercion or exploitation.

The weakness of this theory lies in the labour theory of value upon which it rests. According to Bohm-Bawerk, it is completely wrong to assume that all economic goods are the product of labour alone because other factors such as natural factors also contribute to the production process. Furthermore labour quantities are not proportional to exchange value. It only enters the determination of value through its influence on scarcity.⁵⁶

2.5.2.6 Keynes Liquidity Preference Theory

Keynes'⁵⁷ theory of liquidity preference explains that the rate of interest depends upon the state of liquidity preference, on the demand side and the quantity of money on the supply side. According to Keynes, the rate of interest can be defined as "the reward for parting with liquidity for a specified time." The decision to keep money in liquid assets or in the form of bonds or earning assets will determine the rate of interest. In Keynes' analysis the supply of money is fixed but the supply of bonds will depend on the speculative demand for money. If the supply of bonds exceeds its demand; at very low interest rates and at high bond prices, almost everyone will prefer to hold cash with the expectation that the price of bonds will fall and the rate of interest will rise. On the other hand, if the demand for bonds exceeds its supply; at low bond prices and high rates of interest, speculation will increase the demand for bonds and hence its price leading to a fall in the rate of interest. The rate of interest is determined by the supply and demand for money, indicating an exclusive monetary phenomenon where the effects of real factors are absent.

⁵⁶ Conard 1959:35.

⁵⁷ 1936:167.

The flaw in this theory is that it presupposes the existence of interest. In Keynes' argument every wealth earner conceives a 'normal' rate of interest which exists at any one time. If the current rate of interest is higher than the normal rate, cash holding is discouraged and bond holding is encouraged with the speculation that the price of bonds will rise in the future. However, according to Robertson,⁵⁸ "interest in the liquidity preference theory is merely a risk-premium against fluctuations about which we are not certain. It leaves interest suspended, there being interest because there is interest.". How the 'normal' rate of interest is perceived in the first place is not explained.

It is also argued that by ignoring the factors that causes the existence of interest and focusing on the determination of the interest rates the liquidity preference theory has shifted our attention to the problem of value when in essence the question of interest is a problem of distribution.⁵⁹

From the above survey of the theories of interest it is evident that no clear justification for the existence of interest can be established. What is apparent is that the problem of interest has been viewed from three divergent perspectives. The productivity theory treats interest as a problem of production. The exploitation theory explains it as a problem of distribution while the monetarists seek in the theory of interest the problem of value. Presumably the debates on the theory of interest will not cease to continue despite the fact that the negative effects of interest can be felt in all sectors of the economy.

⁵⁸ Afzalur Rahman 1980:45.

⁵⁹ Mannan op cit:123.

2.5.3 The Negative Effects of Interest

The economic rationalization for the prohibition of interest has been presented in the light of the *Quran* and in terms of the weaknesses in the theory of interest. In addition, the rationale of the Islamic law against interest can also be seen from the negative effects which interest inflicts on society and the economy. A little reflection is sufficient to unravel the negative effects of interest on various sectors in the economy especially the productive sector, the consumers and government. As this subject has been widely discussed by Muslim writers in the past (Siddiqi 1983, Ahmad Z 1984, Mannan 1985) it will be briefly discussed here to support the Islamic rationalization of the prohibition of interest.

The negative effects of interest in the production sector are mainly exerted on the small producers who are often deprived of the opportunity to expand because of their inability to secure loans from the bank. In general, the advancing of loans by banks to the productive sector is determined largely by the collateral and the creditworthiness of the borrower rather than by the viability of potential projects. It is argued that since banks in the interest -based system are generally interested in recovering the principal sum lent plus interest, their main concern would be the safety of their capital and the ability of any venture to generate a cash flow which can meet the interest liability. As a result loans are generally given on the ability to pay criterion, hence depriving small businesses which cannot provide collateral as security to the bank.

Consumers, in general, suffer from the negative effects of interest by paying an indirect tax to the lenders because entrepreneurs often transfer the cost of interest to consumers in terms of higher prices. The higher the rates of interest the higher

the marginal cost of production. As a result prices of consumer goods in the market could go beyond the purchasing power of most households. The result of an inflationary situation, as depicted by the Great Depression in the early thirties and the recession of the present time, causes a dampening effect on aggregate demand leading to massive unemployment.

The Third World debt crisis of the early 1980s is a classic example of the adverse effects of interest on government borrowings. The crisis was triggered by the dramatic rise in interest-rates in the United States under the Raegen administration in 1979, which forced the interest charges on Eurodollar loans to increase three times between 1977 and 1981. The rise in interest rates had a disastrous impact on debtor countries. Countries that failed to meet their loan repayments had to resort to debt-rescheduling forcing them into a vicious circle of higher servicing cost, longer loan obligations, growing balance of payments deficits and recession.

2.6 The Islamic Alternative to Riba

2.6.1 The Concept of Profit

The prohibition of *riba* does not imply that capital has no price in an Islamic economy. Islam recognizes the role of capital in production and hence its entitlement to a reward. However, as has been clearly established at this stage, it is the practice of remunerating capital with a fixed and predetermined reward that Islam disapproves of.

The *Quranic* percept that Allah has forbidden *riba* and permitted trade (*Quran* 2:275) broadly implies that the Islamic alternative to *riba* lies in the institution of trade. It is the consensus among Muslim jurists that the permission to trade is an

indication firstly that profit, the gain from trade, is *halal* (legally permissible) and secondly that the remuneration for capital is and should be tied to profits.

Profit, with the exception of 'exploitative' profit, is recognized in Islam by virtue of its property as a justified and logical form of return to capital and enterprise. Unlike *riba* which is an *ex ante* payment that must be met whatever the outcome of enterprise, profit represents an *ex post* residual which is neither fixed nor definite. Even though the expected rate of profit can be anticipated beforehand, the actual amount of profit realized is entirely determined by the market through the price of the ultimate product relative to the cost of factors used in the process of production. Hence the magnitude of profits can either be positive, zero or even negative in the event of losses. It is this variable and uncertain nature of profits that is acceptable to Islam. Profit, unlike *riba*, reflects the actual outcome of enterprise in the face of business uncertainties which cannot be avoided in the market. A clear relationship, can therefore be traced between profit and enterprise. It can be argued that the Islamic view on profit as a return to enterprise resembles Schumpeter's theory of profits (1963) to the extent that profits arise from entrepreneurial innovation. According to Schumpeter 'profits result from "new combinations" or innovations which are the outcome of entrepreneurial action. Entrepreneurs pay for resources at the prices set by previous uses. Innovations enable a more productive combination of these resources and hence lead to a surplus.'⁶⁰ The notion that profits originate from innovation is consistent with the Islamic belief that Allah has created between man a diversity of capabilities and that man will not earn more than he has strived for.⁶¹ An entrepreneur who is highly organized and innovative is more likely to earn higher profits than one

⁶⁰ Khan S 1984:109.

⁶¹ Al-Quran 6:165, 61:10.

who lacks such capabilities and effort.

However good entrepreneurship does not always guarantee profits. An enterprise is exposed to the risk of losses because of the presence of market uncertainties which lie beyond the control of the entrepreneur. An unexpected change in consumer taste, an abrupt rise in the price of raw materials or a sudden breakdown in production machinery amount to uncertainties which will either increase cost or decrease sales proceeds contributing to a fall in profits or even bring losses. The willingness of the entrepreneur to face such uncertainties and run the risk of losses in the anticipation of profits reflects a just and logical means of factor compensation acceptable to Islam.

Following the positive attitude of Islam towards trade and profits Muslim writers unanimously agree that when capital is to be obtained externally by enterprise, profit-sharing would serve as the most appropriate Islamic alternative to *riba*.

2.6.2 Profit-sharing

By profit-sharing the debtor-creditor relationship is replaced by one of principle and agent or that of a partnership. In a profit-sharing relationship profits are redistributed between the entrepreneur (user of capital) and the supplier of funds (the owner of money capital) as compensation for their share of contribution towards the realization of profits. What this necessarily means is that profits in Islam is a reward which has to be divided between capital and enterprise. In profit there is the gain on entrepreneurial effort and the gain on capital. Islamic economists view profit as the result of the combined effort of capital and enterprise.⁶² It is argued that money capital is only "potential capital" which re-

⁶² Uzair 1982, Hasan 1985

quires the services of the entrepreneur to transform it into productive use. Capital, therefore cannot exist as a separate factor of production but is regarded as part of enterprise through whose efforts profits can be realized. It should be stressed, however, that the proportion of profits distributed to the supplier of capital is a return on capital ownership and not a return on borrowed funds in the western sense. In profit-sharing, the financier can only claim a share when profits is realized from the use of his capital. capital and no claims can be made in the event of losses. This is because profits constitute a gain on capital while losses amount to its erosion. Hence in the case of a loss, the entrepreneur is obliged to return the capital to its owner minus the amount of losses incurred while he bears losses in terms of unrewarded time and effort spent.

It is quite clear that profit-sharing promotes a healthy relationship between the owners of capital and enterprise since both parties are rewarded in a just and fair manner. In contrast to *riba* where more advantage is given to the creditor than the debtor, profit-sharing grants an equal position to both parties involved. In the first place, both parties have an equal position in sharing profits in accordance to a ratio agreed between them. Secondly, both share the risks of going unrewarded in the event of losses. The provider of capital suffers a reduction of his principal and the provider of enterprise is deprived of any reward for his labour, time and efforts.

There are two types of profit-sharing contracts permissible in Islam which owners of capital and enterprise can enter into, known as the *mudarabah* and *musharakah*. As will be outlined below, there are similarities in the conditions of both contracts in relation to the sharing of profits and losses. However differences in some other aspects do exist between both methods; hence opening a variety of

options by which capital and enterprise can be combined for the common aim of profit-sharing.

2.6.2.1 Definition

Mudarabah is, by definition, a financial contract between the owner of financial capital and the owner of enterprise wherein the owner of capital provides a specified amount of money and acts like a sleeping partner while the entrepreneur who provides the labour and management utilizes that money entrusted to him, in a productive venture with the common aim of earning profit and sharing it between them on an agreed profit-sharing ratio.

Mudarabah is an agency contract. The user of capital acts as an agent on behalf of the supplier of capital. In *mudarabah* the agent is known as the *mudarib* and the supplier of capital or the principal is called the *rabb al-mal*. On liquidation of the *mudarabah* the agent is required to return the capital with the share of any profits attributable to the principal.

Musharakah on the other hand refers to a partnership or joint-venture in which two or more persons combine their capital together to generate profits. It is a form of equity participation similar to the modern concepts of partnership and joint stock ownership.

2.6.2.2 Origins

It is interesting to note that *mudarabah* is not mentioned in the *Quran*, although numerous *hadiths* (traditions) attribute its practice to the Prophet and his leading companions.⁶³ Historically, *mudarabah* was widely practised in Arabia during the

⁶³ Udovitch 1970:172.

Pre-Islamic era. It was approved by the Prophet and consequently retained in Islam because it contradicted no Islamic principles. In fact, because of its widespread practice, the same kind of contract was known by different names to the schools of Islamic jurisprudence in different areas. To the Malikis and Shafi'is in Arabia this contract became known as *Qirad* or, to a lesser degree, *Muqaradah*. Both terms are derived from the words *qirdh*(gnaw) and *qard* (cut) respectively to signify that the owner of capital cuts off the disposition of that sum of capital from himself and surrenders it to the entrepreneur. The Hanafis in Iraq preferred the term *mudarabah*, derived from the expression '*darb fil-ard* or walk on earth ', denoting to travel for the purpose of business.⁶⁴

Profitsharing arrangements resembling *mudarabah* were also practised by medieval European traders around the near Eastern and Mediterranean areas and were probably introduced by traders from the Muslim world. These arrangements became known in Europe as the *commenda*.⁶⁵

With regards to *musharakah* the Hanafi and Maliki schools of Islamic law has divided this institution into two types namely the *sharikat al-milk* or propriety partnership and *sharikat al-aqad* or contractual/ commercial partnership. The first type of partnership involves the joint possession of property either through inheritance or purchase while the latter is established by agreement to a commercial contract by the parties involved. Since profit-sharing can only be conducted in the *sharikat al-aqad* the former will not be discussed as it lies outside the scope of this study.

⁶⁴ Udovitch op.cit:174.

⁶⁵ Udovitch op. cit:172.

Sharikat al-aqad can be based on either capital, labour or reputation.⁶⁶ A contractual partnership based on capital can take the form of *sharikat mufawadah* in which all partners share equality in the amount of capital contribution, equality in the division of profits and losses, equality in the delegation of authority, the provision of surety, financial liability as well as equality in the personal status of the partners. Such a partnership is suitable for any commercial venture in which freedom in making business decisions are required between partners.

Another form of contractual partnership based on capital is the *sharikat inan* which does not require equality in any aspect of the partnership. In contrast to the *mufawada* partnership in which each partner is both the agent and the guarantor for his colleague, the *inan* partnership is based entirely on the principle of agency. Each partner is only the agent and does not guarantee any financial liabilities to any third parties on behalf of his colleague. The *inan* partnership would suit locally-based trade where partners can be conveniently consulted for any business decisions.⁶⁷

2.6.3 Differences between Mudarabah and Musharakah

In view of the importance of *mudarabah* and *musharakah* in the theory of Islamic banking it would be worth to comparing the essential conditions of both contracts in terms of the following:-

(a) Capital

1. Capital for *musharakah* can be obtained from all partners compared to *mudarabah* where capital can only be provided by the principal or *rabb al-mal*. If

⁶⁶ Chapra 1985:252.

⁶⁷ Udovitch op cit:119.

the *mudarib* also contributes a specified amount to the capital contributed by the *rabb al-mal* he is entitled to take the entire profit related to his portion of the total capital before sharing the balance as agreed.⁶⁸

2. Most jurists only accept money capital in *mudarabah* but allow all forms of wealth as capital in *musharakah* provided that their value are assessed in monetary terms. The argument against the acceptance of goods as capital in *mudarabah* is related to the problem of uncertainty in estimating the value of this form of capital at the end of the *mudarabah* contract. In contrast to money which is relatively stable in value over a period of time the market value of goods tends to appreciate and depreciate and this could lead to a dispute concerning the value of capital to be returned and the amount of profits attributable to each party.⁶⁹ To avoid this problem both the Hanafi and Maliki schools developed a simple legal device involving the sale of the goods in question first and the resulting revenue be considered as the capital for *mudarabah*.

(b) Management

The *rabb al-mal* is forbidden from interfering with the management of the *mudarabah*. It is important that the *mudarib* is given the liberty to generate profits within the limits set in the contract without any intervention from the principal. In contrast to the separation between the provider of capital and enterprise in *mudarabah* all partners in the *musharakah* are allowed, in principle, to participate in the management of the partnership although not every partner is required to participate actively. By mutual agreement one or more partners can be elected to manage the partnership.

⁶⁸ Chapra 1985:250.

⁶⁹ Homoud 1985:200, Udovitch op cit:180.

(c) Profitsharing

The division of profits in both *mudarabah* and *musharakah* must be stated in an agreed ratio and not in an absolute fixed amount. With the exception of *sharikat mufawada* which requires equal profit-sharing ratios between partners, any proportional ratios are acceptable in the *mudarabah* and *sharikat inan*. The agreed profit-sharing ratio may not necessarily be in proportion to the amount of capital contribution although the partner or partners who run the *sharikat inan* may receive a larger fraction of the profits as a return for their service.

(d) Liabilities

In the *mudarabah*, any losses incurred in the ordinary cause of business will be borne by the *rabb al-mal*. His financial liabilities is limited by the amount of capital contributed. The *mudarib*, on the other hand, does not bear any financial liabilities but will suffer losses in terms of his time and efforts. However the *mudarib* will bear responsibility if losses are incurred as a result of his negligence or carelessness.

In the case of *musharakah*, losses will be shared among the partners in proportion to their respective amount of capital contribution. Limited financial liability is applicable only to *sharikat inan*. The financial liability of partners in *sharikat mufawada* is unlimited where the claims of third parties can be extended to the personal property of the *mufawada* partners.

By comparing the conditions of *mudarabah* and *musharakah* listed above it is seen that there are various ways for different people to come together for the aim of profit-sharing. Those with either capital or expertise can combine their resources in *musharakah* and share in the profits generated. For those without capital but possess the entrepreneurial skills the goal towards profits can still be

attained through *mudarabah*. Similarly, the owners of capital who lack the time or talent can still put their wealth into productive use either through *mudarabah* or *musharakah*.

2.7 Conclusion

As we have seen in the first part of this chapter the Islamic economic system is an integral part of the Islamic system of life. Economic relationships are very much governed by ethical values that the economic behaviour of the Muslim differs from that of the economic man in many respects. Although the discussion of the Islamic economic system may seem utopian in nature, there can be no harm in this approach⁷⁰. Since the model represents the system that all Muslims wish to accomplish it will serve as 'the frame of reference' in any Islamic economic analysis. It serves as a logical starting point in the same manner that the model of perfect competition has preceded more realistic analyses of market imperfections in conventional economics.

⁷⁰ Ariff 1982:2.

Chapter III

The Development of Islamic Banking: A Literature Review

3.1 Introduction

It is shown in the previous chapter that the Muslim worldview on economics and finance is part of an integrated and comprehensive overall system based on Islamic values. The widespread establishment of interest-based banks in Muslim countries, first by foreigners during the period of western colonisation (since the beginning of the nineteenth century) and then by indigenous bankers after independence did not, however, reflect this worldview nor did it fulfil the needs of devout Muslims for an interest-free banking system.⁷¹ Although the idea of Islamic banking began to develop in a number of writings from the late 1940s it only became a reality with the establishment of the Islamic Development Bank (IDB) in 1975 followed by the Dubai Islamic Bank and the Kuwait Finance House in 1977. By 1986 over forty Islamic banks and twenty other Islamic investment and finance companies have been established worldwide.⁷² One of the latest newcomers into the Islamic banking community is the Bank Muamalat Indonesia which opened its doors in July 1992.

It is the aim of this chapter to examine how the Islamic principles have been applied in the development of Islamic banking both in theory and practice. A survey approach will be undertaken. The theoretical literature on Islamic banking

⁷¹ For a treatment of the establishment of European banks in the Islamic world by the nineteenth century see El-Ashker 1987 pp 25-27.

⁷² Ahmad 1987:9.

will be reviewed first. This will be followed by a survey of how far the theoretical ideas have been put into practice. In particular, the results of cross-country surveys and individual case studies will be discussed.

3.2 Theoretical Perspectives

The objective of this section is to survey the main aspects of Islamic banking that have emerged in theory.

3.2.1 Early Thoughts

The earliest references to the concept of Islamic banking appeared in the late 1940s, as shown in the works of Qureshi (1946) and Mahmud Ahmad (1952). However as observed by Ariff⁷³, only passing references were made to Islamic banking in these publications as wider issues relating to Islamic economics were their main focus. Most of these references were brief and rather general relating to the possibilities of how interest-free banking could be implemented. Hence, Qureshi in his book *Islam and the Theory of Interest* sees the Islamic bank as a public sector institution giving what is an essentially a social service, like that of public health or public utilities, because the bank would neither pay interest on deposits nor charge interest on loans.

The possibilities of replacing debt-financing with a partnership between the bank and businessmen who seek capital from the bank was envisaged by Ahmad (1952) in his book *Economics of Islam* where he sees the establishment of the Islamic banks on the basis of a joint stock company with limited liabilities. Deposits are to be received on the current account and the partnership account as addi-

⁷³ 1988:52.

tional sources of the bank's funds with no returns for the former and a share of profits for the latter. Bank lending on the basis of equity participation was also proposed. However, as observed by Ariff (*ibid.*) neither the working principles of equity participation nor the sharing of losses between the bank and its customers were clearly defined.

Instead of further expansion into the potentials of equity participation or *shirakat*, the principle of *mudarabah* or principal-agency was advanced by subsequent writers as the main premise of interest-free banking. The notion of a two-tier *mudarabah* was introduced by Uzair (1952). The two-tier system enables the Islamic bank to mobilize deposits on the basis of *mudarabah* and then disburse or invest these funds also on the principle of *mudarabah*. The work by Uzair was highly regarded by later writers for it systematically laid out how the principles of *mudarabah* can be applied in the interest-free bank. Siddiqi⁷⁴ points out that

the work contains the core of all the future proposals on the subject by basing the respective relationship between the bank and its depositors and between the bank and the businessmen on the principle of *mudarabah*.

The issues of profit distribution and the responsibility for losses were taken up by Al-Arabi (1966). The significance of this work lay in the fact that both issues were resolved in strict accordance with the *Shariah* by which profits arising from a *mudarabah* contract were to be divided upon a mutually agreed profit sharing ratio while financial losses were to be borne wholly by the financier.

A more systematic attempt at developing a comprehensive model of Islamic banking was made by Siddiqi in 1968. The work, entitled *Banking Without In-*

⁷⁴ 1982:23.

terest was written in the Urdu language and was later translated into English in 1983. This model is based both on the principles of *mudarabah* and *shirakat* or *musharakah*. Like Uzair and Al-Arabi, Siddiqi envisaged a two-tier *mudarabah* relationship between the bank and its depositors as well as between the bank and the entrepreneur-borrower. The mechanics of each transaction were described in considerable detail and illustrated with many hypothetical and arithmetic examples. Siddiqi⁷⁵ also envisaged that interest-free banking could operate successfully “only in a country where interest is legally prohibited and any transaction based on interest is declared as a punishable offence.”

3.2.2 Mainstream Theory of Islamic Banking

Based on the principle of the two-tier *mudarabah* a theory of Islamic banking built entirely on the replacement of interest by profit-sharing was developed by contemporary writers on Islamic economics. This theory advocates that only through *mudarabah* and *musharakah* can the banking system achieve the socio-economic objectives of the Islamic economy and eliminate all forms of transactions associated with *riba* from the financial system. Siddiqi⁷⁶, as the leading author of this theory writes that

....modern writers on Islamic economics are unanimous that any reorganization of banking will have to be done on the basis of *shirkah* and *mudarabah*.

Ziauddin Ahmad⁷⁷ further emphasizes that

.... all the chief merits of Islamic banking compared to interest-based banking in respect of

⁷⁵ 1983:13.

⁷⁶ 1985:9.

⁷⁷ 1987:13.

attainment of Islamic socio economic objectives devolve on the replacement of a fixed charge on capital by profit/loss sharing.

In its simplest form the model of the Islamic bank would involve a triangular relationship between three parties namely

1. the depositors who are the suppliers of savings or capital funds,
2. the bank which serves as a partial user of the capital funds and as an intermediary link; and
3. the entrepreneur-borrower who are the actual users of the capital funds.

Based on the conditions of *mudarabah* as explained in Chapter II, it is envisaged that the Islamic bank would receive 'investment account' deposits from its depositors on the basis of *mudarabah*, at the first tier, with the agreement that these deposits will be invested and any net profits generated will be shared between both parties on a mutually agreed profit-sharing ratio.⁷⁸

Hence in the first tier depositors are treated as capital owners or *rabb al mal* whose deposits will be a function of profits in the production sector. The bank acts as the agent or *mudarib* and each party will have a share of the net profits yielded by the investment undertaken by the bank. The share of net profits to the bank constitutes a return for its share of contribution (in the form of labour) towards the realization of profits while the share of profits to the depositors represents a

⁷⁸ No specific rule on the determination of the profit-sharing ratio has been formulated yet. Uzair (1982) and Siddiqi (1983) propose that these ratios be determined by the forces of demand and supply in the market but at the same time be regulated by the Central Bank as a policy variable to reduce money supply and inflation. Other Muslim writers (Saqr 1978, Al-Jahri 1982, Naqvi 1983), however oppose such intervention by the Central Bank. Saqr regards such intervention as non-Islamic because these ratios are part of the initial contract made by mutual agreement between the individual parties and should only be altered by mutual consent. Free market bargaining seems the more acceptable method of determination in view of the Islamic principle.

gain on the use of their capital. It follows therefore that in the event of a loss the depositors will bear a reduction in their deposits in proportion to the financial loss incurred while the bank's loss takes the form of unrewarded labour.

The second tier of the *mudarabah* arrangement involves the bank and the entrepreneur-borrower. At the outset the bank will pool together the deposits in the investment accounts and then disburse them as capital to the entrepreneurs also on the principle of *mudarabah*. In contrast to its position in the first tier, the bank now becomes the full provider of capital or the *rabb al-mal* and takes the responsibility of bearing all financial liabilities in the event of a loss while the entrepreneur takes the role of the agent or *mudarib*. Profits earned from the projects undertaken by any individual entrepreneur will be shared with the bank at a mutually agreed profit sharing ratio. The share of profits that accrues to the bank will in turn be shared between the bank and the depositors at the first tier as described earlier.

The division of profits between the three parties can be summarized in the following equations:-

Assuming that:

π = total business profits realised on the investment of *mudarabah* funds;
given by total revenue (R) less total cost (C) where ($0 < \pi > 0$).

β = bank's profit-sharing ratio in the second tier where ($\beta > 0$)

α = depositor's profit-sharing ratio in the first tier where ($\alpha > 0$)

D = total investment deposits in the bank.

M = total *mudarabah* funds supplied by the bank.

(i) Beginning at the second tier, the share of net profits, r_{B1} , received by the bank from the entrepreneur is represented by

$$r_{B1} = \frac{\beta\pi}{M} \quad 3.1$$

(ii) The share of net profit, r_E , which accrues to the entrepreneur is expressed as

$$r_E = \frac{(1 - \beta)\pi}{M} \quad 3.2$$

(iii) The amount of net profits, r_B , received by the bank will then be shared with the depositors at the first tier. Hence the share of net profits, r_D , received by the depositors from the bank is equals to

$$r_D = \frac{\alpha\beta\pi}{D} \quad 3.3$$

(iv) The net share of profits, r_B gained by the bank as an intermediary between the depositors and the entrepreneur is equivalent to

$$r_B = \frac{(1 - \alpha)\beta\pi}{D} \quad 3.4$$

3.2.3 Relative Stability of the Islamic Banking System

The theory of Islamic banking advocates that one of the major advantages

of an Islamic banking system based on profit-sharing is the ability of the system to absorb shocks compared to the conventional system. Firstly, as evident from equations 3.1 to 3.4 the entrepreneurs, the bank and the depositors will all stand to gain or lose together in the Islamic banking system leading to a fairer distribution of profits between the three parties. Hence the higher the profits, (π) , realised from the project undertaken by the entrepreneur, the higher the net profits, (r_E) , gained by the entrepreneur at the second tier and the higher the returns, (r_D) , to the depositors at the first tier and the net share of profits, (r_B) to the bank. Since deposits are not guaranteed a fixed return but linked to the actual returns (which may be positive, negative or zero) in the production sector, Siddiqi⁷⁹ argues that the profit-sharing system would be more stable than the interest-based system causing less bankruptcies and bank failures. This is because in the profit-sharing banking system any shocks to the bank's asset position, for instance caused by a fall in revenue from investment, would be absorbed on the liability side where profits paid to the depositors' would adjust automatically to the change.

Khan (1987) has attempted to analyse the alleged relative stability of the profit sharing system by considering the dynamic variant of the standard IS-LM model subject to several assumptions.

Based on the assumptions that prices are fixed and that (i) banks are the only intermediaries between saving and investment in the capital market, (ii) the nominal value of deposits on the liability side is not guaranteed by banks while the rate of returns on deposits is variable and not predetermined, (iii) investments in the form of borrowings to the economy constitute the only form of banks' assets; and (iv) money in the money market consists solely of currency exogeneously

⁷⁹ 1988:37.

supplied by the government and that the proportion of wealth held in the form of money depends negatively on the real rate of returns on deposits, Khan formulated the balance sheet of the simplified aggregate banking system in real terms as

$$Assets = Liabilities$$

$$\frac{S}{P} = \frac{y}{r} \quad 3.5$$

where

S = nominal value of shares

P = price level

y = real income

r = real rate of return on shares

Since prices are fixed the real value of the banks' deposits (s) is equal to the capitalized value of the future earnings of the banks as given by:

$$s = \frac{y}{r} \quad 3.6$$

The model ensures that equilibrium continuously obtains in the money and capital market while real income in the goods market adjusts slowly to any variations in excess aggregate demand. Using the basic system as depicted in Figure 3.1 Khan assumes an IS shock in the form of an exogenous fall in real bank income on the asset side, from y^* to y_1 . At point B there is an excess supply of money that causes an instantaneous decline in the real rate of return on investment deposits

from r_* to r_1 at point C. As the real rate of return declines during this process of adjustment, the real value of shares (as given by equation 3.6) falls immediately from

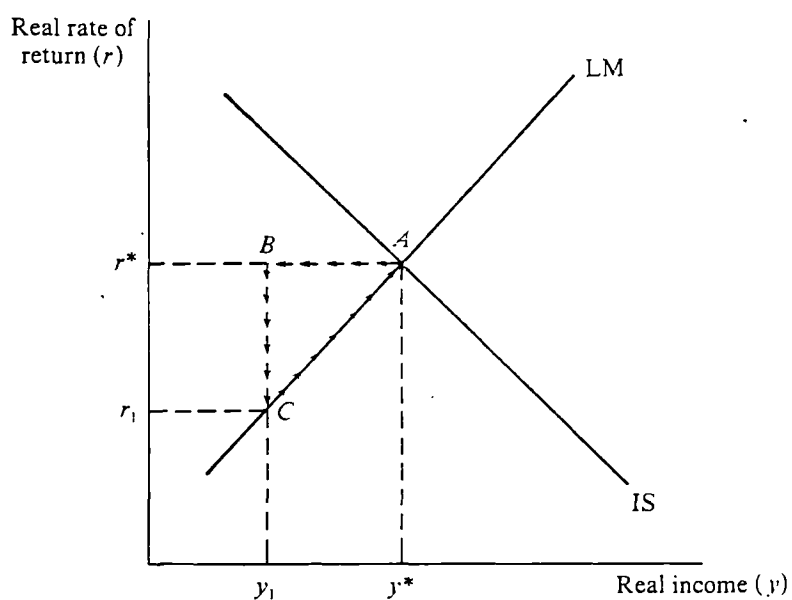
$$s^* = \frac{y^*}{r^*}$$

to

$$s_1 = \frac{y_1}{r_1}$$

to maintain continuous equilibrium in the capital market.

Figure 3.1 — Islamic Banking System with Fixed Prices



Long run equilibrium will once again be reached at the original steady state

as the excess demand in the goods market (at point C) slowly moves real income back to y^* .

The main point that Khan wanted to emphasize in this model is that because the nominal value of deposits is flexible, disequilibrium in the capital market immediately clears hence ensuring the stability of the system. Khan therefore argues that

in a system of equity participation (like Islamic banking) which excludes predetermined interest rates and does not guarantee the nominal value of deposits, shocks to the asset positions are immediately absorbed by changes in the values of shares (deposits) held by the public in the bank. Therefore, the real values of assets and liabilities in such a system would be equal at all points of time.⁸⁰

Digressing from Khan's model, a different situation prevails in the interest-based system where banks receive a predetermined fixed interest irrespective of the level of profit realised by the entrepreneur in the production sector. The revenue from interest which accrues to the conventional bank from its lending activity, given that other costs remain constant, can be represented by equation 3.7

$$r = iP \tag{3.7}$$

where

i = rate of interest

P = amount of principal lent to the borrower

⁸⁰ 1987:31.

Hence even if the borrowed funds from the bank yield high profits to the entrepreneur-borrower the return received by the bank out of the borrowed funds remains uniformly fixed at iP .

The net profit or income for the entrepreneur-borrower after deducting the cost of capital plus interest is given by equation 3.8

$$r = R - P(1 + i) \quad 3.8$$

where

R = net revenue from the project.

In so far as the interest cost iP is less than the net revenue from the project the entrepreneur would find little difficulty in settling the cost of borrowing and sustain a positive net profit. However if the return from the project is lower than the interest cost, the entrepreneur runs a loss but is still obliged to pay the full amount of the loan plus the interest cost, out of his own wealth or by borrowing from other sources. If a large number of borrowers fail to pay their loans during the recession, for instance, the bank's asset position will be affected and since the rate of interest on deposits is fixed a divergence would arise between the real assets and the real liabilities of the bank. As argued by Khan⁸¹ banks may try to cover the discrepancy between assets and liabilities through a drawdown of reserves or by reducing net capital. However if losses exceed available reserves, the banks are likely to be unable to pay their depositors leading to the possibility of runs on deposits or bankruptcy. Unless the Central Bank moves in rapidly to correct the

⁸¹ 1987:ibid.

disequilibrium and restore public confidence bank panic might arise and trigger a sequence of other bank failures causing instability to the whole banking system.

According to Waqar Masood Khan (1985) no such instability would arise when banks issue shares (or investment deposits) to its depositors. In fact he envisaged that under such a system depositors would be more inclined to retain their deposits or shares when the value of the bank's assets decline with the hope of future revaluation of the bank assets; rather than make withdrawals and accept a loss on initial deposit.

The inherent instability of the traditional interest-based banking system has also been recognized by western economists (Fisher 1937, Friedman 1957, Simon 1948, Mintz 1950) even before the current theory of Islamic banking was developed. Simon (1948) believed the bank failures in the United States during the 1930s were closely related to the inherent instability of the fractional reserve system. He proposed reform requiring the replacement of the traditional banking system by two separate institutions namely deposit banks and investment trust in order to differentiate the payment and portfolio functions of banks. The former which receives only transaction balances are required to hold 100 per cent cash reserves to guarantee payment which will avoid bank runs. The investment trust, on the other hand, would obtain funds for lending on the basis of equity participation and consequently the lending activities would be constrained by the amount of funds obtained.

It may be interesting to note that Simon's proposal for 100 per cent reserve requirement did not gain popular support initially because the banks had the opportunity to use deposit insurance. However recent market innovations along the

lines of Simon's proposal have developed in the wake of the banking crisis in the early 1980s. These alternatives which were described as 'mutual fund banking' or 'unit trust banking' based on the idea that 'banks operate as mutual funds, valuing and redeeming deposits according to the current value of their asset portfolio (which could be more or less than the face value).'⁸² Under this alternative system the payment activities of the bank are run-proof through the backing of transaction balances with liquid marketable assets (such as Treasury bills) rather than cash. The investment activities of the bank are effectively unregulated but are also invulnerable to runs. As argued by McCulloch⁸³:

money market mutual funds, like all mutual funds, are run proof since their obligations to their investors are simply pro rata shares in the current value of the funds portfolio. To the extent that depositors/investors line up at the front door to take their money out, the rate of return to depositing new funds will increase and new depositors/investors will line up at the back door to put their money in.

The equity-related activities of these mutual fund or unit trust funds bear resemblance to the profit sharing Islamic bank at least on the deposit side. On this count it is envisaged that there is some theoretical basis to suggest that Islamic banking would be relatively more stable than the conventional banks.

3.2.4 Efficiency in Resource Allocation and Distribution.

The theory of Islamic banking also advocates that the replacement of interest by profit-sharing would result in a more efficient allocation of resources in the economy.

⁸² Lewis 1987: 142.

⁸³ see Lewis 'Domestic and International Banking'1987:143.

Chapra⁸⁴ argued that under the profit-sharing system the rate of interest is replaced by the rate of profit as the criterion for the allocation of resources in the short and long run. The rate of profits also acts as the mechanism for equating the demand and supply of capital.

Resource allocation to various sectors of the economy in the short-run will be determined by the *ex-ante* or expected rate of profit. Thus the higher the profits expected from a certain economic sector or type of business, the greater would be the flow or supply of investment directed to it and vice-versa. The allocation of resources in the long run, on the other hand, will depend more on the *ex-post* or actual profits realized. If *ex-post* profits from a certain sector are consistently lower than the *ex-ante* profit then such sector may find it difficult to attract or raise capital in future.

According to Chapra the two-sided evaluation of projects both on the basis of *ex-ante* and *ex-post* profits provides a check on the misallocation of resources. Decisions will be made entirely on economic factors and the rate of return will be the true allocator of funds. Higher profits reveal efficiency in the real sector and will not reflect factors that influence the interest-rates such as speculation in the interest-based system. The variable profits also acts as a greater incentive for the entrepreneur under the profit-sharing system to strive and make the highest profit possible. On the other hand, since the risk of financial loss will be borne entirely by the bank or shared with the entrepreneur under the profit-sharing agreement banks will be induced to extend credit on the basis of productivity and viability in order to minimize such risk.

The lending criteria of Islamic banks therefore differs from that of traditional

⁸⁴ 1985:108.

banks. A bank working on a profit-sharing system has to ensure that it is financing a specific project that is profitable and that will self-liquidate the 'loan' based on the production, distribution and the sale of the goods and services produced. It is argued that interest-based commercial banks generally place more importance on the credit-worthiness of borrowers rather than on the purpose of the loan or the productivity of the project to be undertaken.⁸⁵ Even though many commercial banks in the interest-based financial system undertake feasibility studies to secure their loans against bankruptcies despite the collateral guarantee most commercial banks in developing countries do not apply such rigorous techniques resulting in many loans being extended on the basis of collateral irrespective of how the funds would be utilized. It is therefore envisaged that a shift to profit sharing in such environments would improve the allocation of resources more effectively.

It is also alleged that resources under the profit sharing system would be equitably distributed⁸⁶. In the first place, since there is no obligation that profits must exceed the rate of interest on borrowed funds the entrepreneur is still able to make a positive return even when profit is low and share this profit with the bank. The important implication here is that under the profit sharing system projects with low profits but which are beneficial from the socio-economic perspective will stand a chance of acquiring bank financing. Secondly as projects would be more closely monitored and supervised by banks under profit sharing than under conventional banking less collateral would be required by the former. Because of this reduced requirement on collateral it is expected that new entrepreneurs with limited wealth but who are innovative would also be eligible for bank financing. This is a major advantage attributed to the profit sharing system. It opens the door to

⁸⁵ Salama 1984:6.

⁸⁶ Chapra 1985:110.

the small-scale entrepreneur who may have potentially high-yielding projects but whose chances for financing in the interest-based system may be slim because of the lack of collateral.

In summary, Muslim economists seem to agree unanimously that there is more to Islamic banking than the mere elimination of interest provided that the main banking operations, both on the liabilities and assets sides, are run on profit sharing. As shown in the above discussions through profit sharing or equity participation Islamic banking can contribute towards the achievement of full employment and economic growth, socio-economic justice and the equitable distribution of income, mobilization and investment of savings and stability in the financial system all of which constitute part of the goals and objectives of the Islamic economy.

3.2.5 Operational Framework

3.2.5.1 Definition

An Islamic bank is defined in broad terms by *The International Association of Islamic Banks* as a bank which

implements a new banking concept in that it adheres strictly to the rulings of Islamic Shariah in the fields of finance and other dealings⁸⁷

In specific terms, however an Islamic bank can be defined as

an institution which conducts all its financial operations, as normally conducted by a bank, in conformity with Shariah, without involving itself with *riba* in any way⁸⁸

⁸⁷ Mudawi 1984:2.

⁸⁸ Ausaf Ahmad 1987:2.

The second definition incorporates both aspects of banking and *Shariah* on an equal footing. As indicated by Khan⁸⁹ an Islamic bank has to meet two basic requirements. Firstly its operations must be based strictly on Islamic principles and secondly it must fulfill all the requirements of sound banking. It is therefore indicative that the Islamic bank faces the technical constraints usually imposed on banks and is also subject to the legal and ethical constraints provided by the *Shariah*. The performance of the Islamic bank is evaluated not only in financial terms but also by the criterion that its profits should be Islamically justified. The existence of an independent *Shariah* Advisory/Supervisory Board is therefore an essential feature which differentiates the Islamic bank from the conventional bank.

3.2.5.2 Objectives

While profits constitute the primary objective of Islamic banks Muslim economists also emphasize the socio-economic objectives which Islamic banks are expected to fulfill. Chapra (1985) asserts that Islamic banks should play a goal-oriented role rather than merely a profit-maximising role and should adjust themselves to the different needs of the Islamic economy. Muazzam Ali⁹⁰ adds that...

The Islamic financial system cannot be introduced merely by eliminating *riba* but also by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance of justice, equity, fairness and human considerations.

The socio-economic objective attributed to Islamic banking relates to the integrated nature of the Islamic economy where the financial system cannot operate

⁸⁹ 1982:187

⁹⁰ 1985:60.

in isolation oblivious to the goals of the economy in which it is an integral part. It must be appreciated that the abolition of *riba* in Islam is not an isolated injunction but it is part of a social and moral philosophy and an integral part of a set of inter-related values (as shown in Chapter II). Thus the objective of Islamic banking, as seen by Muslim economists, is not confined to the elimination of interest from the conventional system but to introduce a new system which contributes positively towards achieving the socio-economic objectives of the Islamic system.

Among the objectives of an Islamic bank as outlined by the International Association of Islamic banks are:-

(a) To mobilize and consolidate resources in the economy through the development of individuals' saving awareness.

(b) To direct funds into investment activities that serve the objectives of the economic and social development of the Islamic nation.

(c) To carry out banking activities and services in accordance with Islamic jurisprudence free from usury and exploitation.

3.2.5.3 Sources and Uses of Funds

While *mudarabah* and *musharakah* are regarded by Muslim scholars as the real substitutes for interest, it is recognized that some difficulties may arise in the application of profit-sharing in certain sectors. This is especially true when deposits are meant for transactionary or precautionary purposes and when financing are needed for consumption purposes. To meet such situations, the literature on Islamic banking has identified other categories of deposits and financing for the Islamic bank as permitted by the *Shariah*. Various sources and uses of funds therefore make up

the structural framework of the Islamic banking operations.

1. Sources of Funds

Apart from equity, deposits are the major source of funds for the Islamic banks. Khan and Mirakhor⁹¹ have divided these deposits into two forms namely transaction deposits and investment deposits.

- Transaction Deposits

These deposits are transaction balances which are comparable to demand deposits (current and savings account) in conventional banks. The nominal value of these deposits is guaranteed by the bank and deposits may be withdrawn at any amount on demand. Generally, no profits are payable on the current account and for this reason the service may be provided free of charge since the cost of maintaining the accounts is sufficiently offset by the benefit which accrue to the bank from the utilization of these deposits. On this argument, a fee on the current account is regarded by some jurists as a disguised interest and therefore should not be permitted.⁹² The payment of profits on the savings accounts depends on the agreement between the bank and the depositors. If the bank is given the right to invest these deposits in short-term financing then profits are payable either at the discretion of the bank or on a mutually agreed ratio.

- Investment Deposits

Investment deposits constitute the principal source of funds for the Islamic bank operating on the profit-sharing system. These deposits which are accepted on the principles of *mudarabah* resemble shares in a firm rather than time and sav-

⁹¹ 1987:5

⁹² Presley 1988:21.

ings deposits of the conventional banks. Thus unlike in the conventional system where the nominal value of deposits are guaranteed, the nominal value of investment deposits is not guaranteed nor is the bank obliged to pay a fixed return on these deposits. There are two main types of investment account deposits; specified and unspecified. The former is limited and conditional in nature since the investment of these deposits are channelled to certain sectors or projects as specified by the account holder. The latter is unconditional which allows the bank to invest the deposits in any suitable projects according to the discretion of the bank. Investment account deposits may be held for short-term periods of one, three, six, nine or twelve months or for longer periods of up to five years.

2. Uses of Funds

As elaborated in the theory of Islamic banking a large portion of the assets of the Islamic bank should be utilized into investment-related financing, namely *mudarabah* and *musharakah* so that the bank can play a developmental role in the economy.

Under *mudarabah* the bank would provide business enterprises or individuals with 100 per cent financing for a particular economic activity on the basis of profit sharing. The entrepreneur would undertake the management of the venture without any interference from the bank. Profits would be shared according to a mutually agreed ratio. Financial losses would be borne entirely by the bank while the entrepreneur loses in terms of his time and effort put into the venture.

There is no complete unanimity among the major schools of Islamic thought on the areas to which *mudarabah* may be applied. The *Hanafi* school restricts its usage to trading activities such as buying and selling while some *Hanbali* jurists

allow its application to finance agriculture, small businesses or workmanships. A majority of scholars also insists that the *mudarabah* should only be confined to self-liquidating transactions because in such cases the assets of the *mudarabah* can be easily identified and liquidated and the proceeds can be easily distributed with the termination of operations.⁹³

The other form of profit-sharing method of financing is *Musharakah* which is similar with *mudarabah* except that funds are not wholly provided by the bank but are contributed by both parties in the form of a joint-venture or equity participation. Unlike *mudarabah* financing, both parties can participate in the management of the joint-venture. Profits are to be shared according to an agreed profit sharing ratio while losses would be borne by both parties in proportion to the amount of capital invested.

The second category of financing which the Islamic bank can undertake is based on contracts of exchange or sale transactions. These methods are regarded as *second-line technique* in the Islamic banking literature since the purpose of their application is to supplement *mudarabah* and *musharakah* in areas where profit sharing is not feasible. Basically the theoretical literature has identified three main contracts of exchange that can be employed by the Islamic bank.

1. *Murabahah* (cost-plus or mark-up sale)

Murabahah which literally means a way of making a profit is basically a two-tier sale mechanism. Under this arrangement the bank buys the goods needed by a client and then sells the goods to the client at a mark-up price. In principle, the mark-up has to be negotiated between the two parties and cannot be determined

⁹³ Presley 1988:24.

unilaterally by the bank. The client can settle the price of the goods either in a single payment at the end of a specified period or in instalments.

It may be worth noting that even though the mark-up seems to resemble interest it is in fact distinguishable from the latter. Although the profit margin is fixed and certain it is Islamically legitimate because it represents profits from a business transaction, not a return on borrowed funds. To be consistent with Islamic law, the *murabahah* transaction must satisfy two conditions. First, the bank must take physical possession of the good or asset before selling it to the client. By this the bank takes the full risk of the purchased goods. Secondly, to avoid *riba* the profit margin should not be altered after the agreement has been concluded. Once the sale price is fixed it cannot be altered even if the client settles the payment earlier or later than stipulated.⁹⁴

2. *Bai' Muajjal* or Sale at a Deferred Higher Price

*Bai' Muajjal*⁹⁵ is similar to *murabahah* in many respects where the bank first buys an asset on behalf of its client and then sells the asset to the client at a price higher than the actual cost of the asset. The asset is delivered on the spot but the payment is deferred. The main difference between the two transactions is that *murabahah* is generally applied for short-term commercial financing (to finance trade bills or working capital) while *bai' muajjal* is normally used for long-term financing for the acquisition of fixed assets or property. The longer payment is deferred under *bai' muajjal* the higher would be the profit margin set by the bank.

3. *Ijarah* (leasing or hire-purchase)

⁹⁴ El-Ashker 1987: 150, Khan & Mirakhor 1987:170.

⁹⁵ also known as Al-Bai Bithamin Ajil.

Here the bank acquires a certain asset needed by the client and then leases the asset to the client at a fixed rate (which would cover the cost of the asset and income for the bank) over a specified period of time. Leasing is a fixed payment contract which is permissible in Islam. Although a fixed charge is levied on the client it does not amount to *riba* because the benefit which flows to the client from the use of the asset is certain. Besides, the bank retains ownership of the asset and hence is exposed to risks and depreciation of the asset due to wear and tear.

Another variant of this contract is the *ijara wa istigna* or hire purchase by which the client ultimately has ownership of the rented asset by paying the value of the asset plus rent over the agreed period. In this case, the bank's share in the ownership of the asset decreases and that of the client increases until the client gets full possession when the full value of the asset has been paid.

Besides financing activities, the Islamic bank is also permitted to provide conventional fee-based banking services such as bank draft, sale and purchase of foreign exchange, travellers' cheques, remittances and transfers.

The bank can also advance interest-free benevolent loans or *qard-alhasan* on compassionate grounds to some of its regular customers or shareholders who are in need of finance to alleviate genuine liquidity crises in the short-term.

Apart from the above instruments the literature on Islamic banking has also recognized the need for the development of instruments for the secondary market. These instruments may take the form of profit-linked certificates issued by companies authorised to raise capital either through *mudarabah* or *musharakah*. In the case of *mudarabah* the bank would provide capital to a *mudarabah* company and in return would receive *mudarabah* certificates with a specific face value. The issue of

Musharakah certificates on the other hand would involve a number of parties who provide capital to a *musharakah* company. Both the *mudarabah* and *musharakah* certificates are redeemable and can be traded in the secondary market. The prices and implicit returns are to be determined by market forces. These financial instruments are essential for, among others, they act as a means of channelling more funds into the primary market for capital accumulation. They enable purchasers to adjust their liquidity positions and convert their claims into cash whenever the need arise and allow financial institutions to raise funds for long-term financing without having to match maturities or for capital without changing their ownership structures.

In summary it can be deduced that the operational framework of Islamic banking as perceived in theory has a greater orientation towards 'investment banking' and 'merchant banking' rather than pure commercial banking. With the abolition of interest other instruments outside the periphery of conventional commercial banking have been devised within the rules of the *Shariah*. The use of profit sharing arrangements makes the commercial bank in the Islamic economy almost equivalent to an investment bank. Its involvement in trade-related financing carries an image of merchant banking yet the developmental role attributed to it brings it closer to a development bank. The great emphasis on profit sharing stresses the commitment expected from Islamic banks towards socio-economic development.

It is because of this multidimensional nature that Chapra⁹⁶ has described the Islamic bank as a multipurpose bank; a crossbreed of commercial and investment bank, investment trust and investment-management institution. Looking from

⁹⁶ 1985:154.

another perspective, Rabooy (1988) argued that because of the unique characteristic of the Islamic bank, it is more akin to an Islamic “intermediary investment company”⁹⁷ rather than a bank.

3.2.6 Issues in Transition

The theoretical model of Islamic banking based on profit sharing assumes a fully-fledged Islamic financial intermediation in an Islamic economy where the behaviour of the economic agents follows strictly to the Islamic ethics in the *Shariah*. It represents an ideal model which does not fit any of the existing Muslim society today. Nevertheless such a model provides a convenient and logical starting point; as a frame of reference, in analysing the real world of market imperfections.

Based on the above view, it is envisaged that the establishment of Islamic banking in the interest-based financial system of Muslim countries represents a period of transition towards the permanent Islamization of the whole economy in the long-run. During this transitional period the implementation of an Islamic banking system based on profit sharing poses several practical problems. Among the main problems addressed are:-

i) Moral Hazard

In the Islamic system honesty and integrity are essential for the successful implementation of profit sharing based on *mudarabah* or *musharakah*. The determination of the exact amount of profits earned by the *mudarib* would be necessary to calculate the bank's share of profits. During the transitional period it is expected that Islamic banks would face a dual risk; firstly the business risk which

⁹⁷ It is interesting to note that the Kuwait Finance House, and Dar al Islami are registered as companies or trusts not as banks to be able to carry out trade financing and equity participation.

arises when the *ex-post* behaviour of market forces differs from the *ex-ante* and secondly the moral risk which relates to the possibility of cheating by fund users who may not declare accurately their profits to the bank because of lack of honesty hence depriving the bank of its due share of profits or even part of the capital supplied.

The problem of moral hazard is less serious in the capitalist system where the obligation to pay a fixed interest irrespective of the outcome of business provides incentives for better management in order to reap profits. In this context Waqar Masood Khan (1985:105) suggests that some financial schemes embodying some incentive mechanism may be devised so that fund users reveal the truth even if they are not sufficiently afraid of God. Chapra (1982) and Siddiqi (1989) conceive that the moral risk would tend to be high in the beginning when the system is newly established. When users of funds realize that their ability to secure loans in future depends on past records of good profits the tendency to cheat will decline substantially.

ii) Competition from interest-based banks

The model of financial intermediation in the transition period is more complex because of the presence of competition from interest-based banks. On the deposit side the behaviour of depositors is not only influenced by the inter-temporal decision of allocating their income between savings and consumption but also by the prospective rate of return between profits and interest. While pious Muslims are expected to prefer Islamic banks over conventional banks on grounds of piety alone the preference behaviour of the non-Muslims and other Muslims with lesser degree of piety is likely to be influenced by the differences in the rates of return, the level

of services and facilities that both banks can offer. It is assumed that depositors in the main are risk averse; and because of the uncertainty associated with investment deposits Islamic bank must be able to offer competitive rates of returns which are higher than that offered by conventional banks by a *risk premium* to compensate for the greater risk involved.⁹⁸

Nienhaus (1989) also envisaged that Islamic banks in interest-based environment would face an instrumental disadvantage compared to conventional banks. Whilst Islamic banks cannot employ all the instruments available to conventional banks the reverse, however does not hold. Conventional banks are not constrained to adopt Islamic financial instruments if they find these instruments are viable. In the final analysis the tool box of conventional banks is actually or potentially greater than that of Islamic banks, which may affect the market share of the latter.

iii) Legal Impediments

Even though the operations of Islamic banks are concluded under Islamic methods of financing these contracts do not come fully under the jurisdiction of the existing civil laws. In countries where the legal system are based on English legal principles civil courts are not sufficiently acquainted with the rationale of these contracts to be able to handle disputes. In practice, disputes relating to these transactions were dealt with according to the interpretation of English law which are more often not in line with the Islamic law. In essence therefore the relationship between the bank and client, which is that of creditor and debtor is still left unchanged. Legal reforms are therefore necessary to safeguard banks and customers against defaults and other abuses.

⁹⁸ Yaacob 1986:113.

iv) Trade-Financing versus Profit-sharing

Great stress has been laid by Muslim economists upon the fact that trade financing must be regarded by Islamic banks only as a supplement to investment financing. The Council of Islamic Ideology Pakistan points out that even though the methods under trade financing are free of interest these alternatives are no more than a second best solution from the viewpoint of an ideal Islamic economic system. It is envisaged that profit sharing or investment-related financing must form the principal financing operations if the socio-economic objectives of the Islamic economy are to be achieved. Thus it is vital, according to the theorists, to treat *mudarabah* and *musharakah* as *first-line techniques* of financing and the other contracts of exchange as *second-line techniques*.

The main concern of the Muslim economists is that because of the inherent simplicity of the profit margin method of financing and the relatively low risks involved, there exists a tendency for Islamic banks to prefer these alternatives to profit sharing. Such a tendency would lead to a concentration on trade financing in the banks' financing operations hence negating the theoretical expectations on the relative superiority of the Islamic banking system. This is because financing would only be channelled to the tertiary sectors hence depriving the primary sectors of real investments where the multiplier effects are greater. It is conceived that concentration on trade financing would result in a misallocation of resources with its associated generation of lower employment and income than can be attained by investment-related financing. As noted by Attiyah;⁹⁹

Murabaha is not suitable except for trading activities. As a result the capital deposited in Islamic banks invigorates only trading activities whereas the assumption was that it would be

⁹⁹ in Siddiqi 1989:56.

distributed over all kinds of activities and between different sectors...So the ultimate result of the employment of these huge funds in murabaha deals is to narrow down the activities of Islamic banks in comparison to what they were expected to do in the light of the Islamic economic vision.

Some writers are also wary of the danger that the trade financing alternatives would be abused by the banks in the pursuit of high profits. Siddiqi¹⁰⁰ cautions that these alternatives may serve as channels for

opening a back door for dealing on the basis of *riba*.

He argued that the determination of the mark-up can lead to discrimination where the margin will tend to be higher the longer payment is deferred. This would impose a burden on the client and if the rate of instalment is fixed (where the client is obliged to pay at the stipulated time) then the economic effects similar to that of interest can be expected. Ziauddin Ahmad (1985) emphasized the point that if the interest-based system is replaced largely with a system based on mark-up then the change would denote a change only in name rather than in substance for the new system would not be free from the negative effects of the interest-based system. The bank bears no real risk and the inequitable distribution of gains between the bank and the clients closely resembles the interest system.

Siddiqi¹⁰¹ even went to the extent of suggesting that these methods of trade financing be abolished. He quotes,

I would prefer that Bai' Muajjal is removed from the list of permissible methods altogether.

Even if we concede its permissibility in legal form we have the overriding legal maxim that anything leading to something prohibited stands prohibited. It will be advisable to apply

¹⁰⁰ 1985:139.

¹⁰¹ 1983:227.

this maxim to Bai' Muajjal in order to save interest-free banking from being sabotaged from within.

Siddiqi further adds,

Should some pressing situations defy any other solutions, we can at least confine the use of Bai' Muajjal specifically to them as a temporary measure, while prohibiting its use in other situations.

This is an extreme suggestion that needs to be considered seriously especially from the point of Islamic jurisprudence. The contracts of exchange are clearly permissible in the *Shariah* since they are conducted within the boundaries of sale or rent and not borrowings. It therefore follows that the income derived from these sale contracts are permitted irrespective of whether there is a risk involved or not. Moreover these contracts are essential for cases where financing cannot be carried out on profit sharing. In the final analysis no one has the right to pronounce lawful things as unlawful except Allah. If the harm coming from a lawful thing is proven greater than its benefit then it should be greatly discouraged but not declared as unlawful. What is more important, as envisaged by Mirakhor (1987) is for the banks themselves to assess the appropriate trade off between risk¹⁰² and return to ensure the safety of their overall portfolio of assets. If banks are constrained from engaging in trade-related financing the portfolio of the bank must be considered very risky. On the other hand, banks do not operate at optimum if they refuse to consider profit-sharing activities solely because of the risks involved even though the expected returns from profit-sharing activities exceed the expected return from markup. The relevant factors to be analysed by the bank are its overall earnings and the riskiness of its total portfolio rather than the risk of a particular

¹⁰² Risk here is interpreted as variability of expected returns (Mirakhor 1987:194).

mode of financing considered in isolation.

3.3 Islamic Banking in Practice

Even though the first attempt at Islamic banking was made in Pakistan in the late 1950s¹⁰³ the more well-known experiment was the establishment of an interest-free savings bank in the rural town of Mit Ghamr, Egypt from 1963 to 1967. This pioneer scheme was aimed to change the attitude of the rural population towards savings and investment and to industrialize the villages without government intervention. Besides its success in changing the behaviour of the rural population from hoarding to financial savings, the most notable contribution of the bank was the provision of investment loans on the basis of profit sharing to small enterprises, entrepreneurs and artisans who had the skill but not the funds to set up their own businesses.¹⁰⁴ One of the unique features of the bank was the inculcation of the sense of belonging by the bank management to the population. Hence by continuous emphasis that the bank belonged to the people and by bringing in representation of the local people into bank management, social control against loan defaulters was exercised which attributed to the success of the loan schemes.¹⁰⁵ Despite its success the bank lost its operational autonomy in 1967 when it was brought under the control of the National Bank of Egypt and the Central Bank in 1967 due to political reasons. Nevertheless the developmental nature of this experiment made it very prominent.

The emergence of the current breed of Islamic banks both in the Middle-East and the West in the second-half of the 1970s may be attributed largely to the im-

¹⁰³ Wilson 1985.

¹⁰⁴ El-Ashker 1990:60.

¹⁰⁵ Mannan 1985:171.

pact of the Islamic resurgence and the substantial petrodollar income. The concept of Islamic banking was first formally discussed at the Third Islamic Conference of Foreign Ministers in Jeddah 1972. A document which later became known as the "Egyptian Study "addressed the basic issues in relation to the functioning and operations of Islamic banks. It was proposed that Islamic banking was to be implemented in three stages.

- The first stage would involve the establishment of an Islamic Advisory Agency to provide advisory assistance in the establishment of any Islamic banking institution.¹⁰⁶
- The second stage would be the setting up of an international Islamic bank to serve as a clearing house for international payments between Muslim countries and finance reciprocal trade. Central agencies at the national level were to be created to prepare for the subsequent establishment of local Islamic banks.
- The third stage would see the formation of local Islamic savings, investment, and development banks to complement the umbrella institution at the national and international levels.

Nevertheless the practical development of Islamic banking took a different course. The advisory agency, namely the International Association of Islamic Banks (IAIB) was not set up until 1977 two years after the establishment of the the first Islamic bank. In addition, the national central agencies proposed for the second stage have yet to materialize in the various countries.

¹⁰⁶ Wholers-Scharf 1983:77.

3.3.1 Classification

The Islamic banks in operation have been classified into different categories according to different criteria. Ahmad¹⁰⁷ has divided these banks on the basis of the purpose of their formation into three groups namely;

(i) The commercial banks which are formed to provide normal commercial banking services in accordance to the *Shariah*. The basic aim of these banks is to make profit. Most of the existing Islamic banks belong to this group.

(ii) The development banks which are to foster the process of social and economic development amongst member governments. The Islamic Development Bank is the only existing example.

(iii) The special-purpose Islamic banks which have been established to fulfill some specific purpose or to serve a special class of clientele. Examples are the Nasser Social Bank of Egypt and The Islamic Bank of Western Sudan. These banks offer great potential in bringing social and economic change to its clients.

An IMF study by Iqbal and Mirakhor (1987) however classifies the Islamic banks according to the environment in which they operate. By this classification the Islamic banks fall into two categories.

1. Islamic banks operating in full-fledged Islamic financial systems as in the Islamic Republic of Iran and in Pakistan.¹⁰⁸
2. Islamic commercial banks or Islamic investment companies which operate in

¹⁰⁷ 1987:13.

¹⁰⁸ It may be worth noting that an Islamized banking system was briefly implemented in Sudan between September 1984 and April 1985. However many commercial banks reverted to the conventional system after the Numeiri regime was overthrown.

the conventional system side by side with the traditional financial institutions. These banks may be further divided into two broad groups in accordance to their financial structures. The first are Islamic banks in Muslim countries established either by private or semigovernment initiatives. Examples are the Faisal Islamic banks in Sudan, Turkey, Bahrain, Guinea, Senegal and Egypt, the Al Baraka Islamic banks in Turkey, Sudan and Jordan; the Kuwait Finance House, and Dubai Islamic Bank. The second are investment holding companies operating in some Muslim but mostly in non-Muslim countries; belonging mainly to the the Dar-Al-Maal-Islami (Geneva) and the Al-Baraka International Limited (England).

3.4 General Evaluation of Performance

3.4.1 Islamic banks in the Islamized economy

The IMF study by Iqbal and Mirakhor (1987) contains observations on the experience of Islamic banking in both Iran and Pakistan where the entire banking systems have been Islamized. Individual country case studies have also been carried out by Aryan and Gieraths (1990) respectively.

Banking in Iran underwent a three-year period of transition which began, following the Islamic revolution in 1979, with the nationalization of more than twenty privately-owned banks that were facing a crisis of confidence and bankruptcy. As a result of the nationalization exercise the number of banks in the financial system was reduced to five commercial banks and four specialist banks.¹⁰⁹

¹⁰⁹ Aryan 1990:156.

The first step towards the Islamization of the banking system, however, took place in 1981 when commercial banks, under the advice of the Central Bank, replaced interest on loans with a 4 per cent service charge while deposits were offered a 'guaranteed minimum profit' instead of interest. A lengthy period of consultation for the submission of a comprehensive bill of Islamization of the entire banking system was to follow. Consequently, the Law for *Riba*-Free Banking was passed in August 1983, by which the whole banking system was required to transform all its operations in line with the *Shariah* within a period of three years. Hence by March 1985 the whole banking system in Iran was Islamized.

Under the new Law, the banks were required to convert all their liabilities within a year into two types of deposits acceptable by the *Shariah*. Deposits for transactionary and liquidity purposes under the Islamic system are to be mobilized as *Qard al-Hasanah* deposits which would constitute savings and current deposits that yield no returns. However to attract savings the banks are permitted to offer a variety of bonuses either in cash, kind or priority in the use of banking services. The banks are also authorized to accept investment deposits with specific minimum periods of maturities ranging from three months for short-term deposits and one year for long-term deposits. These deposits are received on the basis of profit-sharing. The rate of profit is uniform for all banks and is determined by the Central Bank based on the overall profits of the banking system. Profits are declared every six months and depositors who withdrew their investment deposits before the minimum maturity period are not entitled to any profits. Aryan¹¹⁰ reports that deposit mobilization under the new system has been quite successful. By 1987, private sector deposits with the banking system have risen in nominal

¹¹⁰ 1990:166.

terms to 20.5 per cent from 5.7 per cent in 1985. The bulk of total deposits (77%) were investment deposits of which 60 per cent matured in the short-term. The rates of profit for investment deposits have been relatively high ranging between 6 per cent and 8.5 per cent for short-term and long-term deposits respectively.

In terms of asset utilization, Article 3 of the new banking law stipulates the use of the term investment deposits in "joint venture, *mozarebeh*, hire purchase, instalment transaction, *mozaraah*, *mosaqat*, direct investment, forward dealings and *joaalah* transactions¹¹¹". Nevertheless, the pace of Islamic conversion was relatively slower on the asset side. Aryan¹¹² noted that during the first year of Islamic operation the banking system was only able to extend 16 per cent of total credit to the private sector in Islamic forms. This accounted for less than half (30.5%) of total investment deposits in the banking system which implied that the available deposits had not been fully utilised. In addition, a major portion of the financial resources have been allocated mainly to finance short-term trade and commercial transactions under instalment sale (*murabaha*) rather than for project financing under *mudarabah* or *musharakah*. The bias towards short-term trade financing was attributed, according to the IMF study, to the inadequate preparation on the part of the commercial banks to carry out their new role as development banks under the Islamic system. One of the major constraints was the shortage of trained personnel to appraise potential projects for long-term financing under profit-sharing and to monitor the progress of approved projects. Aryan¹¹³ also adds that improper and unclear legal definitions regarding private property rights and contracts under Islamic banking have also given rise to uncertainties pertaining

¹¹¹ Siddiqi 1988:48.

¹¹² 1990:166.

¹¹³ 1990:169.

to the distribution of assets acquired by long-term investments in agriculture and industry. To avoid such problems, banks had preferred to concentrate their assets in short-term trade financing.

The Islamization of the banking system in Pakistan was less abrupt than the Iranian experience. The banking system was not nationalised. Instead Pakistan had opted for a gradual process beginning with the introduction of interest-free 'windows' operating side by side with the interest counters of the conventional banks to accept deposits on the basis of profit and loss sharing (PLS). During this first phase which lasted from 1979 to 1 January 1985, steps were also taken to develop new interest-free financing instruments in which the PLS deposits could be invested. To implement these instruments three major finance institutions¹¹⁴ had earlier converted all their transactions into interest-free methods of financing in 1979 and a new development finance company, Bankers Equity Limited, owned by the nationalized banks, was also set up. By July 1982 domestic banks had the option to invest their PLS funds Islamically in methods such as mark-ups, hire-purchase, *musharika* and leasing in any of the four Islamized finance institutions.

The final abolition of *riba* was announced in June 1984. All finance transactions by the government, state enterprises and stock companies had to operate without interest by January 1985. The whole domestic banking system was finally geared to Islamic banking in July 1985. Nevertheless foreign currency deposits and loans from abroad were exempted from the new regulations.

The new system is characterized by twelve modes of non-interest finance on the asset side. As can be seen in Table 3.1 the Islamic banking system in Pakistan

¹¹⁴ House Building Finance Corporation (HBFC), Investment Corporation of Pakistan (ICP) and National Investment Trust (NIT).

was also dominated by trade-related financing rather than equity-participation and profit-sharing. There were six methods of trade financing relative to four based on profit-sharing while the remaining two were fee-based services.

Table 3.1 — Pakistan: Interest-free methods of Financing

Trade-Related	Investment-Related	Others
1. mark-up/murabahah	7. musharakah	11. Qarz-e-hasna
2. mark-down	8. equity	12. service charge
3. buy-back	9. participation term	
4. leasing/ijara	10. rent-sharing	
5. hire-purchase		
6. development charge		

Source: Gieraths (1990:80)

The mark-down and buy-back methods are unique to Pakistan. The former which is in effect a reduction of the mark-up by a bonus was introduced to overcome the problem of late payments of installments and therefore act as an incentive for early or punctual payments. The buy-back agreement, on the other hand allows clients to purchase movable and immovable property by first selling the goods to the bank and simultaneously buys back the same goods at a higher price (mark-up) payable at a future date either in instalments or as a lumpsum. Although this instrument is allowed by the State Bank of Pakistan, it is not permissible under the *Shariah* according to most Islamic banking authorities because the supplier and the bank client are the same person. The transaction is fictitious and exists only on contract paper and is not linked to a real goods transaction.¹¹⁵

¹¹⁵ Gierath (1990:186-187) has also discovered other discrepancies between the practical applications of the Islamic financial instruments in Pakistan and the rulings of the *Shariah*. For instance

Since the abolition of *riba* financing was replaced by widespread usage of the mark-up system, the IMF study reported that the shift to Islamic banking in Pakistan had not caused any disruption to lending activities. Bankers in Pakistan claimed that the change to Islamic banking would have been tougher without markup since the economy was not mature enough for equity-participation.¹¹⁶ Even in 1987, three years after the transformation, most banks were unwilling to venture into *musharika* or *mudarabah* because of high risks and the reluctance to share in a loss with public money, even though some have set up subsidiaries for leasing and hire-purchase activities. As stated by D.M Qureshi, managing director of Bankers Equity,¹¹⁷

This is the first stage of Islamicisation. The economy is set for mark-up, agricultural, semi-industrial, short-cycle. Mark-up is the most crude form of Islamic finance. More mature is *musharika*, then leasing; the highest is *mudaraba*...Investing in a *mudaraba* means trusting the managers— something that rarely exists in Pakistani business...We have to use *musharika* and *mudaraba* only for very high status clients.

The business risk associated with *mudaraba* and *musharika* was further exacerbated by the absence of legal documents and operational procedures for the usage of Islamic methods of financing other than the mark-up. For example, 30 out of

under the Mudarabah Ordinance the *mudarabah* company has to hold at least 10 per cent of the *mudarabah* certificates floated in the market which according to the Shariah is synonymous to equity-participation. In the case of *musharika*, the distribution of profits between the bank and its clients is based on the profits projected by the latter and the provisional profits that the bank expects. Thus if actual profits exceed the provisional profits expected by the bank the excess is awarded to the client as a managerial bonus before the rest is distributed between him and the bank. However if profits realized do not reach the provisional profits expected by the bank the client must assign an increased share in profit to the bank. In the case of losses the bank is entitled to shares of the company in equal proportion to the amount of loss it suffers. By these arrangements the bank secures a minimum return even if actual profits fall below expectations which in principle violates the conditions of a genuine *musharika* contract.

¹¹⁶ The Banker October 1987.

¹¹⁷ The Banker, October 1987:39.

32 legal documents prepared by the Pakistan Banking Council relate to mark-up financing. As a result the banking system is forced to resort only to mark-up and abandon the other forms of financing.¹¹⁸ This was evident when the mark-up methods of financing accounted for 86.7 per cent of the investment PLS funds of the commercial banks at the end of June 1984. *Musharika* accounted for 3.1 per cent and 8 per cent were in the form of equity participation, Bankers equity, purchase of shares and the like, leaving perceptive observers with “a frustrating feeling”¹¹⁹

In terms of deposit mobilization, the rates of return on PLS deposits were found to be relatively high ranging between an average of 8 per cent for savings deposit and 11.2 per cent for one-year PLS deposits.¹²⁰ These rates were not only relatively higher than the rates of interest on the relevant accounts (7.5% for savings and 10.5% for non-PLS deposits) in the interest-based banks but were also higher than the rates of interest before Islamization. Unlike in Iran, there were variations between the rates of profits paid by banks indicating some degree of competition for deposits. However, a more recent observation by Zaidi¹²¹ shows that with the abolition of interest-based deposits, the average rates of profits on the PLS deposits had fallen to a level below former interest rates even though the profits of banks have generally remained stable or substantially improved after deducting foreign income inflows. This position obviously conflicted with the Islamic economics theory which treated capital and enterprise as a single factor of production by which any increase in enterprise profits must necessarily bring about an increase in the rate of return on capital. A possible explanation for the additional profits

¹¹⁸ New Horizon 1992 June:12.

¹¹⁹ Siddiqi 1988:48.

¹²⁰ Shorter term PLS deposits and less risky savings deposits receive lower weights of profit.

¹²¹ 1987:41.

is that the banks still maintained interest-based loans made before Islamization. Interest income from these loans could not be distributed to the PLS deposits and has therefore gone to the bank and its shareholders as profits.

The IMF study had found no evidence to show that the effectiveness of monetary policies in both Iran and Pakistan was impaired by the conversion to Islamic banking. Credit allocation between the various sectors of the economy as the primary instrument of control (both before and after Islamization) remained effective. The Central Bank of Iran has, however, supplemented this allocation through variations in reserve ratios and moral suasion. Except for the rate of interest, all other monetary policy instruments such as sectoral ceilings of credit facilities and discount rates are still applicable in Iran. Several new instruments have also been introduced to perform the functions previously carried out by interest. One of these is the maximum anticipated rate of return (MARR) which acts as a yardstick to judge the acceptability of some credit applications submitted to banks. The rate which is determined by the Central Bank reflects the opportunity cost of financing other opportunities. Hence banks are authorized to finance an application only if the anticipated rate of return on such financing is at least equal to the MARR. Any project with a lower anticipated rate of return is therefore rejected. The power of the MARR is similar to an interest rate since an increase or decrease in its rate will lead to a contraction or expansion of the volume of credit. Another instrument, the Maximum Rate of Profit (MRP), is also devised to have the same effect of interest and is used by banks as mark-up or cost-plus.¹²² The State Bank of Pakistan also specifies a fixed range for mark-up rates for the same purpose.

The experiences of Pakistan and Iran show that the elimination of *riba* from

¹²² New Horizon June 1992:8.

the entire banking system can be achieved without major problems. However the conversion into a banking system based entirely on profit-sharing and equity participation, as proposed in theory, is more difficult and requires basic changes in the attitude of banks and society from debt-financing to equity-financing. Legal reforms to safeguard the interest of the bank and clients and comprehensive re-training of staff to deal with project-related lending operations are also necessary to facilitate such transformation.

3.4.2 Islamic banks in interest-based environments

Basically, the main aim of Islamic banks in interest-based environments is to offer an Islamic alternative to conventional banking; specifically to provide an opportunity for the Muslim population to avoid *riba* in their banking transactions. An evaluation of the performance of these banks would therefore centre around their ability to penetrate the local markets and continue to survive in the 'hostile' environment. Yet one of the other important aspects of performance would be the extent to which these profit-making institutions have conceded to the socio-economic role expected of Islamic banks in theory.

Even though more than 40 of these banks had been established by the end of the 1980s, only a limited number of comprehensive studies on their performances have been published. The earliest systematic empirical study ever published was that undertaken by Khan F (1983) which covered Islamic banks in the Middle Eastern countries of Sudan, the Gulf States, Jordan and Egypt. A more comprehensive survey by Ahmad (1987) on Islamic banks both in the Middle East and elsewhere compares the performance of these banks until the first half of the 1980s. A collection of more recent empirical studies also focussed primarily on the Middle-



East is offered in the volume *Islamic Financial Markets* edited by Wilson (1990).

Generally, the establishment of individual Islamic banks in the conventional setting has led to the emergence of a dual financial system – usually one Islamic bank against many *riba*-banks. With the exception of the seven Islamic banks in Sudan, three in Bahrain and two each in Egypt and Turkey, the Islamic banks in other countries such as Kuwait, Jordan, Dubai, Qatar, United Arab Emirates, Bangladesh, Malaysia, Indonesia, Guinea, Niger and Senegal enjoy monopolistic positions in the Islamic sector. Market shares tend to vary. The older Islamic banks such as the Kuwait Finance House (KFH) and the Faisal Islamic Bank Egypt (FIBE) accounted for close to 20 per cent of total deposits respectively, between 1982-1984 partly because of extensive branch networks. The performance of the Jordan Islamic Bank (JIB) has also been impressive where it accounted for 7.5 per cent of total bank deposits in 1987. Competition between Islamic banks in Sudan has, however, reduced the market share of the Faisal Islamic Bank Sudan from 15 per cent in 1982 to 7 per cent in 1986.¹²³ For the newer Islamic banks such as the Faisal Finans (FFK) and the Al-Baraka Turk (ABT) in Turkey market shares are still marginal where both banks accounted for 1.2 per cent of the total current and savings deposits held by their conventional counterparts in 1987.¹²⁴ The relatively large market share of the established Islamic banks indicate that there is indeed a market gap for Islamic banking in the conventional environment. The thesis that Islamic banks have reached their ‘limits of growth’ after filling the market gap is rejected by Nienhaus, based on the observation that the market shares of many Islamic banks have increased over time.

¹²³ Nienhaus 1988.

¹²⁴ Baldwin 1990:47.

The earliest survey by Khan indicates that Islamic banks in interest-based environments have been successful in devising methods for the mobilization and utilization of deposits which conform to the *Shariah*. On the liability side, investment accounts based on profit-sharing were found to be most popular. Savings accounts were equally attractive only if these accounts were entitled to a share of the profits of the bank. As in Iran and Pakistan investment accounts are received on the basis of profit-sharing with different periods of maturity. Other studies also show that some Islamic banks, such as the Kuwait Finance House, Faisal Islamic Bank Egypt and Bahrain Islamic Bank, also accept investment deposits for unlimited periods by which the deposits are renewed automatically every year unless written notice is given, as in the case of the Kuwait Finance House, three months before withdrawal.

Ahmad (1987) notes that the deposit structure of the 'old' Islamic banks have undergone significant changes in the 1980s; marked by a general decline in the significance of the current account deposits and the rising importance of investment deposits.

This trend is particularly evident in the case of the Kuwait Finance House (KFH) and the Faisal Islamic Bank Egypt (Table 3.2). During its first year of operation in 1978, 50 per cent of the total deposits of the KFH were current account relative to 26 per cent of investment deposits. By 1983 the share of current account deposits had declined to 11.4 per cent of total deposits while the ratio of investment deposits had risen to 40 per cent of total deposits. The same trend is also evident in the case of the Faisal Islamic Bank Egypt. More than 96 percent of total deposits mobilized in 1983 were investment deposits and 3 per cent were in the current accounts. Similar tendencies were also exhibited by the

relatively new Islamic banks in Turkey where the share of current account deposits to total deposits was relatively lower in 1987 compared with 1985. Conversely, the proportion of investment deposits had increased by 10 percentage points from 84.7 per cent to 94.6 per cent over the same period. The fact that investment deposits form the largest ratio of deposits in these Islamic banks show that Islamic banking has a role to play in the mobilization of investible resources on a *halal* manner. Even though returns on these deposits are not guaranteed in the sense that they are liable to losses, depositors seem willing to accept the risk in view of the expected profits.

Table 3.2 — Islamic Banks: Structure of Deposits

Bank	Year	Percentage of Total (%)		
		Current	Savings	Investment
KFH	1978	50.2	23.3	26.5
	1983	11.4	47.7	40.9
FIBE	1978	24.8	1.1	73.9
	1983	3.3	0.01	96.6
	1987	5.0	not available	95.0
Turkey				
ABT	1985	15.3	not applicable	84.7
& FFK	1987	5.4		94.6
FIBS	1979	82.6	4.4	13.0
	1983	64.6	4.7	30.7
	1987	77.6	10.7	11.7

Source: Derived from Ahmad (1987), Kazarian (1991), Baldwin (1990) and Ahmed (1990)

However, a reverse trend has been observed for the Islamic banks in Sudan. The figures for the Faisal Islamic Bank Sudan (Table 3.2) show that current account

deposits accounted for the largest proportion of total deposits mobilized. The share of investment deposits were just over 10 per cent. Even though these deposits accounted for 30.7 per cent of total deposits in 1987, their ratio has fallen to 10.7 per cent in 1987.¹²⁵ The relatively small percentage of investment deposits was mainly due to the ceiling imposed by the Central Bank Sudan on investment deposits owing to the limited investment opportunities in the domestic economy.¹²⁶

In general the growth of deposits in Islamic banks has been associated with two main factors: i) the state of the economy and ii) the rate of return. For instance, the decline in the growth of current account deposits with the Kuwait Finance House was mainly attributed to the slowdown in business transactions as a result of the fall in oil-prices in the mid-1980s.¹²⁷ In the case of the Islamic banks in Turkey and Egypt deposit growths were largely influenced by the high rate of inflation. As the values of the Turkish lira and the Egyptian pound depreciate against foreign currencies these banks tend to attract a greater proportion of deposits in foreign currencies, hence, resulting in positive relationships between the growth of foreign currency deposits and that of total deposits.¹²⁸

The experience of Islamic banks in Egypt and Turkey showed that the relative rates of return of conventional bank deposits have posed significant influences on the growth of the total deposits of Islamic banks. Kazarian (1990) observes that the deposit base of the FIBE almost doubled every year during the first five years of its establishment when the rates of return on investment deposits were higher than the average interest rates on conventional bank deposits.¹²⁹ However,

¹²⁵ Ahmed 1990:85.

¹²⁶ Ariff:1988:58.

¹²⁷ Wilson 1990:133.

¹²⁸ Kazarian 1991:162.

¹²⁹ For example annual rates of profit ranged between 11.5% and 12% compared to average interest

the bank recorded negative growth rates of total deposits between 1986 and 1988 when interest rates were higher than the profits offered on investment deposits.¹³⁰ Ahmad (1987) notes that the total deposits of the Kuwait Finance House grew at a declining rate from 97 per cent in 1981 to 47 per cent in 1983 when the rates of return on 12 month investment deposits fell from 13 per cent and 7.5 per cent over the same period. The Turkish banks also experienced a decline in the growth of total deposits in 1988 when the gross interest rates of time deposits exceeded the gross rate of return on PLS deposits.¹³¹ These findings imply that even though Islamic banks in the conventional environment may be regarded as an alternative to the conventional banks in attracting deposits, in reality competition for deposits do exist as depositors tend to compare the rates of return offered on their deposits over time and across industry. If the rates of profit do not reach a certain limit that will fulfill the motive to earn, some depositors are likely to invest in other permissible forms of investment or even shift their funds to the conventional banks.

In terms of profitability Nienhaus¹³² pointed out that even though some Islamic banks have had some spectacular losses in the mid-80s it would be inappropriate to draw general conclusions from these particular cases. For instance the loss incurred by the Kuwait Finance House in 1984 because of its heavy investments in the real estate and construction sector was attributed to the collapse of the *Soukh al-Manakh* stock market which also affected other commercial banks in Kuwait.¹³³ Before the crisis, the Kuwait Finance House was the most profitable Kuwaiti bank

rates which ranged between 8% and 10.5% between 1980-1983.

¹³⁰ Average rate of profit was 7.8% compared with 11% average rate of interest.

¹³¹ Baldwin 1990:48.

¹³² 1990

¹³³ Three of the six largest conventional banks in Kuwait recorded zero profits in 1985.

in terms of asset utilization.

In general, the Islamic banks had been successful in generating profits from their assets in the early 1980s. Both the Jordan Islamic Bank (JIB) and the Faisal Islamic Bank Egypt (FIBE) showed relatively higher asset utilization ratios prior to the recession in 1983. Shallah (1989:292) however pointed out that the performance of the JIB in 1987 was lower than the other commercial banks in Jordan but was comparatively better than most leading Arab banks which recorded an average ratio of 0.17 per cent in 1987.

Table 3.3 — Asset Utilization: Net Profit Before Tax To Total Assets
(%)

Bank	1980	1981	1982	1983	1984	1985	1986	1987
KFH	1.46	1.72	2.28	0.50	0.0	0.21	0.32	n.a
JIB	0.12	1.36	2.25	1.02	1.03	0.58	0.54	0.46
FIBE	2.01	0.68	0.57	0.58	0.42	0.41	0.46	n.a

Note:n.a-not available.

Source:Nienhaus (1988), Shallah (1989).

In comparison to the other Islamic banks, the newer Turkish Islamic banks had relatively better results. The ratio of gross profits to total assets of the Al-Baraka Turk was 13 per cent and 17.5 per cent in 1985 and 1986 respectively. The Faisal Finans also registered relatively high ratios of 7 per cent and 8.9 per cent for the same years compared to the KFH, JIB and FIBE ratios which ranged between 2.2 per cent and 5.9 per cent over the period.¹³⁴

¹³⁴ Nienhaus 1899.

In general, as concluded by Nienhaus, Islamic banks operating in interest-based environments have proved their viabilities in terms of financial performance even though there is no clear evidence of the superiority of these banks over their conventional counterparts.

From the perspective of the contribution of these Islamic banks towards socio-economic development, Nienhaus raised the question of whether the individuals who run the banks were aware of the allocative and distributive role of Islamic banking as perceived in theory. This is because the practice of these banks in asset utilization has clearly diverged from the theory. With the exception of the Islamic banks in Sudan where *musharakah* financing accounted for a significant proportion of total financing in the 1980s¹³⁵, other Islamic banks disregarded medium and long-term profit-sharing financing in their funding activities. Like Islamic banks in Iran and Pakistan Islamic banks in the conventional environment have typically resorted to short-term trade-financing based on the mark-up or *murabahah* in the utilization of their resources.

Wilson¹³⁶ reports that "a large proportion of funds advanced by the Kuwait Finance House are for import finance, often on the Islamic mark-up basis." Data on the Jordan Islamic Bank operation also show that the proportion of *murabaha* financing has been increasing annually from 51 per cent in 1984 to 80 per cent of total financing in 1987.¹³⁷ Similarly in Turkey, "the bulk of the funds at ABT and FFK, well over 90 per cent, are used to finance trade, known as *murabaha*

¹³⁵ The proportion of Musharakah to total financing was 56% for the Tadamon Islamic Bank in 1983. The Sudanese Islamic Bank has given the highest priority to this financing instrument. Musharakah accounted for 48% and 61% of total executed operations in 1986 and 1987 respectively.

¹³⁶ 1990:138.

¹³⁷ Shallah 1990:118.

investment completed within 6 months.”¹³⁸

Factors underlying the preference for mark-up financing are very much similar to those that have influenced the Islamic banks in Iran and Pakistan; such as the security of the venture in terms of guaranteed profits, the relative simplicity of the procedures involved especially for the majority of the banks’ officials who were originally trained in conventional banking, the short-term nature of deposits and lack of expertise in project appraisal and monitoring. It was also discovered, that basically these banks do not see themselves as development banks or investment banks but purely as commercial banks.¹³⁹ The commercial orientation had necessarily meant greater emphasis on the financing of ventures associated with the trade and commercial sectors rather than long-term investment projects.

3.5 Conclusion

The survey on the theoretical and empirical literature undertaken in this chapter shows that there exists a dichotomy between the theory and practice of Islamic banking. The divergence seems to be more evident on the asset rather than on the liability side. Empirically, whilst the mobilization of PLS deposits raises very little practical problems, the adoption of PLS methods of financing by Islamic banks either in the Islamic or conventional setting were below the theoretical expectations. The greater concentration on short-term trade financing and the widespread use of the markup financing instrument implies that the expected role of Islamic banking as an effective instrument in socio-economic development will still remain to be explored.

¹³⁸ Baldwin 1990:50.

¹³⁹ Nienhaus 1990.

The case studies surveyed in this chapter also show that a majority of Islamic banks have been established in the Middle-East mostly through private initiatives. Because of this, most empirical studies have been focussed on these Arab banks. However developments in the 1980s also show that Islamic banking is also practised in other parts of the Muslim world. An important example is the Bank Islam in Malaysia which will be the subject of discussion in the following chapters of this thesis.

Chapter IV

The Malaysian Economy: A Background Perspective

4.1 Introduction

When the first Islamic bank in Malaysia was opened in 1983 the Malaysian economy had just undergone a period of impressive growth performance during the 1960s and 1970s and was about to face the uncertain futures associated with the onset of the deflationary effects of the global recession on its main growth sectors. A period of rapid structural adjustments, to accommodate for marked changes in economic growth, was to follow. Since the assessment of the performance of Islamic banking in Malaysia in later chapters will be undertaken in the context of the government economic policies and the economic climate of the 1980s this chapter aims to provide a background to Malaysia focusing on its socio-political and economic aspects in general and special emphasis on developments which took place during the 1980s.

4.2 Geography

Malaysia is a relatively small country situated in the central part of Southeast Asia. It lies between Thailand, Cambodia and Vietnam in the north and Singapore and Indonesia in the south and is bordered by the Phillippines in the east. Geographically, Malaysia is made up of two distinct land regions separated by the South China Sea. Peninsular Malaysia which is at the southernmost tip of the Asian landmass forms the western part of the country and across the South China

Sea in the east are Sabah and Sarawak located on the northern half of Borneo island.

Malaysia lies entirely in the equatorial zone. Because of its equable climate and abundant rainfall the country is well-endowed with natural resources. Four-fifths of Malaysia is covered with tropical rainforest whilst most of the remaining land area is suitably fertile for agriculture. Tin is found in most parts of the Peninsular. The most valuable mineral resource in recent times is petroleum even though tin (beside rubber) was the most important export-earner until the late 1970s. In general, Malaysia's rich endowment of economic resources has made it one of the prosperous countries in Southeast Asia. The population has a mean monthly income of M\$1254 in 1990 and is ranked fifth after the established "tiger economies" of Singapore, Hong Kong, South Korea and Taiwan.

4.3 Socio-Political Background

4.3.1 Population

The latest population estimate¹⁴⁰ shows that Malaysia had a population of about 18 million in 1990. About 81.7 per cent of the population in 1990 was concentrated in Peninsular Malaysia, 8.5 per cent in Sabah and 9.8 per cent in Sarawak.

On average the population is characterized by a high ratio of young people. The median age of the population in 1988 was about 21 years old. About 59 per cent of the total population during the same period were of working age between 15-64 years. Whilst the average annual growth rate was 2.6 per cent per annum

¹⁴⁰ Sixth Malaysia Plan 1991:28.

the growth rate of the working population exceeded that of the whole population which was indicative of a rapidly growing labour force.¹⁴¹ Until the 1980s, a slow growth rate of the population was encouraged. However, in 1984 this policy was reversed to achieve a target population of 70 million by the year 2020. The aim of this policy is to prepare a large labour force which will be needed by the economy Malaysia develops into an industrial nation by the year 2020 as well as a large domestic market for the manufactured goods.

4.3.2 Social Structure

The Malaysian social structure is made up of a plural society comprising five major ethnic groups namely the Malays, Chinese and Indians in Peninsular Malaysia and the Kadazans and Ibans in Sabah and Sarawak respectively. Broadly speaking, however, the multi-ethnic character of the Malaysian population can be categorized into two main groups; namely the *bumiputera* whose cultural affinities are indigenous to the region and the *non-bumiputera* whose cultural affinities lie outside the region. The *bumiputera* (literally 'Sons of the Soils') groups are highly differentiated consisting of the aborigines, the Malays and the indigenes of Sabah and Sarawak. The Malays are the major ethnic community in the *bumiputera* category. The first Malay settlers (the Proto-Malays) were known to have established themselves in the Peninsular as far back as 1000 BC with the movement of people southwards from China through the Southeast Asian landmass and into the Malay archipelago. The non-bumiputera groups on the other hand consist primarily of the Chinese and Indians as the two major communities besides other smaller communities of Arabs, Eurasians and Europeans. In comparison to the Malay *bumiputera*, the earliest massive migration of Chinese and Indians took

¹⁴¹ Mid-Term Review, the Fifth Malaysia Plan 1989:82.

place only in the nineteenth century with the encouragement of the British colonial administration.

The population structure is therefore complicated by the diversity in race and also religion. A majority of the population in Peninsular Malaysia are Malays (estimated at 53% in 1990)¹⁴² followed by the Chinese (31.2%), Indians (9.8%) and others (0.7%). In terms of religion, all Malays are Muslims. Most Chinese are Buddhists or Taoist even though many also choose to worship both deities and perform other ancestral rites associated with Confucianism. There are also other Chinese who adopt Christianity and Islam as their faith. Most Indians, on the other hand, are Hindus although there are also groups of Indians who are Muslims.

Economically, the *bumiputera* community is relatively left behind in all sectors compared to the non-*bumiputera*. About 60 per cent of *bumiputera* live in the rural sectors and are engaged in agriculture. The Chinese who were originally concentrated in the tin-mining areas now control the business and commercial sector in the urban areas. Indians who live in non-urban areas are generally employed in the rubber estates and those in the cities are usually engaged in commerce or are employed in the public services.

4.3.3 Political Perspectives

To provide a better understanding of the Malaysian economic policies of the 1980s and the government support for the Islamic banking project it is necessary to take a brief look at the political scene which had exerted a significant influence in shaping the economic development of the country since independence.

¹⁴² The whole *bumiputera* community accounts for 58.3% of the total population of Peninsular Malaysia.

Firstly, it is generally agreed that because of the plural population the ethnic factor has always been a potent force in Malaysian politics. Since independence the interests of the three main ethnic communities, the Malays, Chinese and Indians have always been represented by communally-organized political parties. Whilst the interest of the Chinese and the Indians are being represented by the Chinese-based and Indian-based MCA and MIC parties respectively, the protector of Malay and hence Muslim interest has always been the United Malay National Organization or UMNO. In fact, the first post-independence government was set up as a democratic alliance between these three parties. To maintain some balance of power between the major ethnic groups, namely the Malays and the Chinese, a policy of political accommodation was adopted by the leaders of the first post-independent government. This was translated into a 'political bargain' whereby equal citizenship, political participation, unimpaired economic opportunity and cultural as well as religious tolerance were to be granted to the non-Malays. In return the Malays were given control of the government and 'special rights and privileges'. Under these privileges, the Malays were to be given certain social and economic advantages by law in addition to their political dominance.

One of the major outcomes of this political pact was a split between political power and economic influence in the 1960s. The three ethnic groups have already been segregated in terms of their residence and economic roles, before independence, by the British policy of 'divide and rule'. Whilst the Malays have been confined to the rural, low-income, subsistence agricultural sector, the Chinese were generally settled as urban dwellers and controlled the high income modern sectors of trade and business. Most Indians, on the other hand, were concentrated in the rubber plantations and remained isolated to some extent from the rest of

the population.

The political pact, coupled by the *laissez-faire* system which restrained the role of the state in the economy further aggravated the inequalities in the distribution of income and economic opportunities between the three ethnic groups and specifically between the Malays and Chinese. Even though the *laissez-faire* system was relatively successful in generating national income and high economic growth on macro terms, the main beneficiaries of the system were generally the large foreign export sector, the domestic Chinese business class and the Malay ruling class. The rest of the population mainly the majority of the Malays in the rural areas and the urban middle-class remained economically left behind and did not see any benefit in such political and economic arrangements.

Many Malays believed that even though the government was Malay-based it neglected Malay interests because of manipulation by the Chinese.¹⁴³ The Chinese on the other hand, also made known their grievances in public. Despite being economically superior they saw themselves as second-class citizens and resented the political privileges being allocated to the Malays. The racial antagonism between the Malays and the Chinese continued to develop and was capitalized by the opposition parties during the 1969 general election campaigns resulting in major erosions of support towards the Alliance. A larger share of Malay voters favoured the opposition Islamic Party (PAS) while many Chinese shifted their support to the Chinese-majority Democratic Action Party (DAP) also in the opposition. The defeat of the Alliance in some of its constituencies stimulated further anxieties between the Malays and Chinese and culminated in bloody racial riots which broke out on 13th May 1969 a day after the general election.

¹⁴³ Jesudason 1989:67.

4.3.4 The New Economic Policy (NEP)

Following the racial riots, the country was run under emergency rule and it was during this period that serious measures were taken to ensure national unity between the major communities. The weaknesses of the constitutional arrangements and the past '*laissez-faire*' policy of high growth in terms of income distribution were recognized. The disparity in the distribution side was evident in the wide differences of income and employment between the Malays and non-Malays. In 1970, the mean monthly income of a Malay household was M\$172 compared with M\$394 and M\$304 of a Chinese or Indian household respectively. In terms of employment whilst the *bumiputera* accounted for 70 per cent of the labour force in the agricultural sector they were highly under-represented in the modern urban sectors. For example in 1970, 61 per cent of registered professionals were Chinese, 23.3 per cent were Indians and a mere 4.9 per cent were *bumiputera*. Disparity in share capital ownership was also significant between the ethnic communities where *bumiputera* individuals and trust agencies owned 2.4 per cent of total share capital of limited companies in 1970 compared to 27.2 per cent in Chinese ownership. To redress such disparities a new economic strategy called the New Economic Policy (NEP) was formulated and introduced in 1971 to be implemented over a period of 20 years until 1990.

It is therefore worth noting that the NEP was the most significant feature in the economic development policies of Malaysia in the 1970s and the 1980s. There were two principal objectives of the NEP. The first was the eventual eradication of poverty by raising income levels and increasing employment opportunities for all Malaysians irrespective of race. The second objective was the restructuring of the Malaysian society in order to reduce and eventually eliminate the identification of

race with economic function. The restructuring process was to target three areas;

i) the patterns of employment so that no single race could be closely identified with a single economic sector.

ii) the pattern of corporate ownership so that by 1990 *bumiputera* would manage and own at least 30 per cent of shares in the corporate sector as against 40 per cent and 30 per cent non-*Bumiputera* and foreign stake respectively.

iii) the creation of a viable *Bumiputera* Commercial and Industrial Community to form at least 30 per cent of Malaysian entrepreneurs by 1990.

One of the direct implications of the NEP was the change of government policy from the non-interventionist *laissez-faire* policy of the 1960s to a policy of expanded state intervention in order to assist the *bumiputera* community in achieving the NEP targets. Public agencies, state corporations and public enterprises were set up as instruments to implement the NEP strategies. This led to an almost oversized public sector. As a consequence at the end of the 1970s Malaysia had one of the largest public sectors among the developing countries¹⁴⁴ which had far-reaching implications on the achievement of the NEP targets in terms of the efficiency and the amount of public expenditure involved.

4.4 Economic Setting

A significant characteristic of the Malaysian economy is its strong orientation towards an open and free-market economy. The role of the export sector is dominant where exports account for 62.3 per cent of Gross National Product (GNP) in 1990 compared to 56 per cent in 1960. Any change in export revenue will affect

¹⁴⁴ Fisk 1982:308.

economic activity in the short and medium term and exerts a pervasive impact on the balance of payments, income, investment, output, money supply and the general price level.

The traditional dependence on the export sector may be attributed to three main factors namely the abundance of natural resources, the favourable world demand for primary commodities in the 1960s and the 1970s and the small domestic market. It is therefore not surprising that structural changes in the Malaysian economy over the 33 years since independence have been largely tailored within the context of the open economy.

4.4.1 Growth

Table 4.1 — Malaysia: Annual Growth Rate(%) of Gross Domestic Product(GDP) in constant prices

Year	1956-60 ¹ (1960=100)	1961-65 (1965=100)	1966-70 (1965=100)	1971-75 (1970=100)	1976-80 (1970=100)	1981-85 (1978=100)	1986-90 (1978=100)
1	2.9	1.4	6.2	10.0	11.6	6.9	1.2
2	2.5	6.9	1.0	9.4	7.8	6.0	5.4
3	0.5	5.5	4.2	11.7	6.7	6.2	8.9
4	4.5	5.8	10.4	8.3	9.3	7.8	8.8
5	9.9	5.6	5.0	0.8	7.4	-1.1	9.4
Average	4.1	5.0	5.4	8.0	8.6	5.2	6.8

Notes:

¹ For Peninsular Malaysia only

Source: Bank Negara Malaysia, Annual Report 1990 Table A1

Compared with most other developing economies the growth record of the

Malaysian economy over the past three decades (with the exception of the mid 1980s) has been generally rapid and impressive. The average annual growth rate of real GDP was 6.2 per cent between 1956-1990 with an 8 per cent average annual growth rate recorded in the 1970s. (see Table 4.1). Similar high rates of annual domestic growth have also been recorded since 1988; the 9.4 per cent growth in 1990 being the highest achieved in recent times since 1976.

4.4.1.1 Growth in the 1970s

The high growth rates during the first two decades after independence were mainly attributed to the favourable international economic environment in the industrialized countries which were the main importers of Malaysian primary commodities. Firstly, Malaysia had benefited from the high world demand for its rubber and tin during the post-war economic boom in the 1950s and 1960s. At independence in 1957, Malaysia was already the largest producer of natural rubber supplying one-third of the total world output of rubber. It was also the largest producer and exporter of tin and accounted for 33 per cent of the total world output.

Malaysia, however, experienced its major commodity-export boom in the 1970s especially between 1975 and 1980 owing to the bouyant prices of petroleum and other primary commodities. Tremendous growth rates in GDP were triggered as total exports volume more than tripled from 1975 to 1980 following the increases in the prices of the country's major commodity exports namely petroleum, timber, palm-oil and even rubber and tin. The main export earner during this period was petroleum. The volume of petroleum exports soared in 1980 as world oil prices more than doubled between 1975 and 1980 and production increased following the

discovery of new oil wells in the east coast of Peninsular Malaysia.

During the same period, the export of sawlogs quadrupled and that of sawn-timber almost tripled as the prices of both timber products doubled. Even though the importance of rubber and tin as the major export earners had declined during the period, the exports of both primary commodities also rose as their prices more than doubled. In the case of palm-oil, its price did not rise over the second half of the 1970s but increased production doubled exports from 1975 to 1980. The increase in export volumes was evident not only among primary commodities but also in manufactured exports. The export of manufactured goods rose from M\$615 million in 1970 to M\$1.7 billion in 1975 and then tripled to M\$6.3 billion in 1980¹⁴⁵

4.4.1.2 Growth in the 1980s

As shown earlier in Table 4.1 the rapid rates of economic growth experienced by Malaysia in the 1970s could not be sustained in the 1980s. The rate of economic growth slowed down in the early 1980s but became more severe in the middle of the decade. The trough of the economic recession was reached in 1985 when real GDP contracted by one per cent for the first time since independence.

The decline in economic growth which began in 1980 had generally been attributed to a number of external and internal factors which characterized the structural weaknesses which had prolonged the impact of the recession into the mid-1980s.

(a) Balance of Payment Deficit

Externally, the onset of the global recession in the early 1980s brought drastic

¹⁴⁵ Jomo 1990:58-59.

changes to the Malaysian export sector which had long been the main source of revenue, employment and foreign exchange for the country. The successive recessions in the United States and the other industrial economies in the early and mid-1980s had adversely affected international trade which in turn weakened the prices of Malaysia's major non-oil primary commodities. Increasing protectionism in the North had also reduced the markets for Malaysian manufactured products but the biggest blow was felt in 1986 when the price of petroleum also dropped steeply leading to a sharp reduction in total export earnings. The overall collapse in commodity prices brought a sharp reduction in total export earnings.

The value of imports on the demand side, however, exceeded that of exports because of the sharp growth in the import of intermediate and investment goods. This was due to the expansion of more capital-intensive manufacturing industries in conjunction with the export-oriented industrialization policy. In 1980, intermediate goods accounted for 49.9 per cent of total imports followed by investment goods (30%) and consumption goods (18.4%). About 60 per cent of the intermediate goods imported were construction materials to support the growth of the construction industry. Infrastructural development under the NEP also contributed to the rising import of plant and machinery.

As a result of the high import intensity and the fall in export values, the balance of payments suffered an overall deficit of M\$1,093 million. Imports of merchandise exceeded exports by M\$ 243 million at the end of 1981. In 1982, although the overall deficit was reduced to M\$614 the merchandise account balance further deteriorated where the value of exports fell short of imports by M\$1,758 million.

(b) Large Budget Deficit

Domestically, internal structural weaknesses were also present. These had exposed the economy to new external pressures hence prolonging the impact of the recession into the mid-1980s. One of the main structural weaknesses was the increased reliance of the government on budget deficits and government borrowings in the 1970s and 1980s to finance greater government involvement in the economy towards the achievement of the NEP targets.

Firstly, whilst government expenditure was mainly directed to finance infrastructural development in the 1960s, its amount had grown tremendously towards the end of the 1970s and the first two years of the 1980s as the government's direct participation in the economy resulted in various commercial and industrial projects undertaken by its public enterprises.

The ratio of public sector expenditure to the GDP increased from 35 per cent in 1971 to 41 per cent in 1972 (following the declaration of the NEP), to 55 per cent in 1980 and 70 per cent in 1981 and 1982¹⁴⁶. The rapid increase between 1981 and 1982 was largely due to two main reasons. Firstly, following the deflationary effect of the fall in export revenue the government had resorted to an expansionary fiscal policy as a counter-cyclical measure to offset the deflationary effect of the global recession. By increasing public sector investment the government had hoped to offset the sluggishness in private-sector investment. Secondly, large public investment was also needed to finance the government's increasing emphasis in heavy industries since mid-1981. These included the setting up of the Malaysian car project, large scale steel and cement production, heavy iron and steel manufacture, the construction of high-rise building complexes and the Penang Bridge.

¹⁴⁶ Jomo 1990:179.

The direct implication of such rapid growth in public spending was manifested in the budget deficit. Between 1979 and 1981 the budget deficit rose by 226 per cent from M\$3483 million in 1979 to M\$11359 in 1981.¹⁴⁷ Correspondingly, the deficit to GNP ratio rose from 7.9 per cent in 1979 to 20.4 per cent in 1981 far exceeding the 1980 world average of 3.3 per cent.

(c) Rising Public Debt

The fall in export revenues between 1981 and 1982 necessarily implies that the large budget deficit had been financed largely by a mix of domestic and foreign borrowings. Until 1980, the main source of financing for public expenditure has come primarily from non-inflationary sources: mainly the current surplus of the public sector and the compulsory social security contributions of the private sector to the Employees Provident Fund. However, with the increasing overall deficit of the public sector, the traditional sources of domestic financing were insufficient to meet the financing requirements of the government. Gross national savings had declined to about 25 per cent of GNP between 1981 and 83. As a consequence, the savings-investment gap, as reflected by the current account deficit in the balance of payments, amounted to almost 12 per cent and had to be met mainly by foreign borrowing. As shown in Table 4.2 net public sector domestic borrowings rose from 15 per cent to 31 per cent in 1982 and subsequently decreased through 18 per cent in 1983 to 9 per cent in 1984. In contrast total outstanding public external debt jumped by 55 per cent during 1980-1, compared to only 9 per cent the previous year. The large increase in foreign borrowings resulted in a dramatic growth in total outstanding public debt from 13 per cent to 29 per cent during the same period. The highest annual rise in public debt over the 1980-87 period was recorded in

¹⁴⁷ Jomo 1990:181.

1982 (37%) when both net domestic and net foreign borrowings rose significantly by 31 per cent and 50 per cent respectively.

Table 4.2 — Outstanding Public Debt (1980-1987) - Annual Increase

Year	Annual Increase (%)		
	Domestic Debt	External Debt	Total Public Debt
1980	15	9	13
1981	19	55	29
1982	31	50	37
1983	18	38	25
1984	9	20	14
1985	70	15	10
1986	12	35	23
1987 ^p	18	2	11

Note:^p preliminary estimates

Source: Jomo (1990:Table 8.9)

The large increase in both domestic and foreign borrowings was used to finance the anti-cyclical public spending measure in 1981-82. Most of the growth in government foreign borrowings after 1980 came from market sources. The proportion of these foreign commercial loans as a proportion of total foreign borrowings rose from 45 per cent in 1980 to 58 per cent in 1981 and further up to 68 per cent in 1982. Much of these market loans were utilized to finance the major heavy industrial projects under the heavy industrialization drive introduced by the government in mid-1981. Since these loans generally involved higher interest rates the burden of external debt on the Malaysian government was significant.

The strains on the government's financial position became increasing apparent in the second half of 1982. Apparently, the increase in government spending did

not produce the desired results. High bureaucracy and inefficiency of the oversized public sector seemed to have slowed down the desired investment multiplier effect. On the other hand the import of investment and intermediate goods remained high to support the industries under the export-oriented and heavy industrialization drive. The balance of payments suffered a trade deficit for the second consecutive year in 1982 and the problem of twin deficits (balance of payments and budget deficits) became unsustainable. In order to contain the growth of the external debt and to reduce overall public sector deficit to a sustainable level as a proportion of the GNP, an austerity drive was started in mid-August 1982. A shift in policy was announced to reduce the role of the government in the economy and to promote the private sector as the main engine of growth. The fiscal adjustment package included restraint in public sector spending in the form of cuts (and abolition in some cases) in various subsidies and other transfer payments, a freeze in public sector recruitment, a moratorium on civil servant salaries, consolidation of the financial position of public sector enterprises and the review of priorities and cost-effectiveness of public sector projects and programmes.

The sluggishness of private investment between 1982 and 1985 was not sufficient to offset the decline in public investment. The overall collapse in commodity prices had brought a sharp decline in overall income which affected new private capital formation. Aggregate domestic demand declined by 4.6 per cent in 1985 compared with an increase of 6.4 per cent in 1984. The fall in aggregate demand was followed by a reduction in gross private investment by 6 per cent in real terms which consequently led to stagnation in domestic activities. Economic growth at the macro level, declined from 7.8 per cent in 1984 to minus one per cent in 1985. The overall result was a steady rise in the rate of unemployment from 5 per cent in

1981 to 6.3 per cent in 1984 and 7.6 per cent in 1985. Unemployment was highest in the agricultural sector (42%) in 1983 and the manufacturing sector (48%) in 1984. By 1985 more than half of retrenched workers were from the manufacturing sector (63%), followed by 20 per cent from mining and 11 per cent from retail trade and related services.

(d) Economic Recovery

Economic growth picked up at a rate of only 1.2 per cent in 1986 as the export price of Malaysia's primary commodities began to slowly improve. Several steps to revive domestic economic activity had earlier been taken by the government since mid-1985.

Among the measures undertaken was the creation of a M\$1 billion National Investment Fund by the Central Bank in September 1985 to encourage bank lending to fund new investments in the productive sectors of agriculture, manufacturing and tourism. In December 1985, a special low-cost housing programme was also implemented to utilize idle capacity in construction and manufacturing especially cement, steel, building materials and labour. New lending guidelines were issued to the banking system which required commercial banks and finance companies to channel loans for the construction of low-cost houses costing between M\$25,000 to M\$100,000. Licensing regulations were liberalized and a wider range of tax incentives for investment in the manufacturing sector was introduced to attract foreign investors.

The important role of the private sector as the engine of growth was further emphasized when the government actively pursued its policy towards privatization. The privatisation policy which involved changing the status of a business, service

or industry from state to private ownership was officially introduced in 1983 to reduce the administrative and financial burden on the public sector. As a result of these measures and incentives, investors' interest from both domestic and foreign sources were revived and with the strengthening of external demand the economy recovered in 1987 when real GDP growth was registered at 5.4 per cent per annum. Since then annual growth in real GDP had gathered momentum and reached almost 10 per cent in 1990, the first annual double-digit growth since 1976.

In line with the shift in public policy, development expenditure under the Fifth Malaysia Plan (1986-1990) was reduced by 35 per cent from the original allocation of M\$74 million to M\$47.7 million. The overall budget deficit as a percentage of GNP also declined from 10.1 per cent in 1986 to 4.7 per cent in 1988. The bulk of the deficit was financed by domestic borrowings as the government took advantage of the favourable domestic market conditions. Some of the funds were also used to prepay several of the more expensive foreign loans thereby improving the nation's external debt profile. Net foreign borrowings rose only by 2 per cent in 1986-87, much lower than the rise of 18 per cent in domestic debt. (see earlier Table 4.2).

4.4.2 Structural Changes

It is obvious that Malaysia would not have been able to substantially benefit from the world commodity price boom in the late 1970s and achieve rapid economic growth if the country had not embarked on the programmes of economic diversification which began in the 1960s. Initially, economic diversification was largely motivated by the problem of economic instability which arose from the over-dependence on rubber and tin exports that were subject to unstable price fluctuations. Later, the policy of economic diversification was intensified to achieve

other objectives such as the eradication of poverty and the restructuring objectives of the NEP.

In general economic diversification has been pursued along the lines of agricultural diversification and export-oriented industrialization. Both policies have greatly transformed the Malaysian economy over the past three decades. Until 1980 development policies have been focussed on agricultural diversification in order to produce a broad-based composition of primary export commodities. However the unfavourable international market prices of these commodities during the recession and the aim of the government to transform Malaysia into a newly industrialized economy by the year 2000 had resulted in a shift in policy from agriculture to manufacturing or industrialization.

Table 4.3 — Malaysia: Changing Economic Structure, 1960-1990

Export, GDP by Sectors				
	1960 ¹	1970	1980	1990
	(% of GDP)			
Export	56.1			62.3
GDP by Sector:				
Agriculture	37.9	32.1	26.5	18.9
Mining	5.9	5.7	3.5	9.7
Manufacturing	8.6	12.2	16.8	26.9
Construction	3.0	4.5	4.7	3.5
Services	44.6	44.7	47.1	42.2

Note:¹ For Peninsular Malaysia only

Source: Bank Negara Annual Report (1990:Table A4)

As shown in Table 4.3 the main trend in the transformation of the Malaysian economy between 1960-90 is the continuous and substantial decline in the relative importance of agriculture in the GDP alongside a rapid increase in manufacturing or industrialization. Agriculture was the largest productive sector in the economy between 1960 and 1980 but its share in GDP has been on the decline from 38 per cent in 1960 to 27 per cent in 1980 and further down to 19 per cent in 1990. Conversely, the share of the manufacturing sector has almost doubled during the last three decades; rising from 9 per cent in 1960 to 17 per cent in 1980 to reach 27 per cent in 1990. With the rapid growth of the manufacturing sector and the low prospects of primary commodities in the international market the relative importance of agriculture in the GDP is expected to be further reduced in the future. In contrast the manufacturing sector is projected to grow 10.5 per cent per annum to contribute 37 per cent of Malaysia's GDP by the year 2000.¹⁴⁸

For the purpose of this thesis, it is relevant to outline in greater detail both diversification policies and the structural changes that have occurred in the Malaysian economy before and during the 1980s.

4.4.2.1 Agricultural Diversification

One of the strategies implemented during the first phase of economic transformation (from 1956 through the 1970s) was agricultural diversification on the supply side. The policy aim was not only to reduce the problem of economic instability which arose from the over-reliance on rubber and tin; but also to create employment for a rapidly growing labour force particularly in the rural areas where agriculture was the mainstay for more than 60 per cent of the population.

¹⁴⁸ The Wall Street Journal Europe:31 July 1991.

Over the first fifteen year period (between 1956 to 1970), agricultural and rural development received the largest proportion of total development allocations (24 per cent) under the country's first three 5-year development plans. The main emphasis in the 1960s was to diversify and expand the agricultural resource-base by increasing the replanting and new planting of rubber; by new planting of oil palm; by the extraction of hardwood timber; by the opening of new riceland; and by the improvement of irrigation and drainage facilities. Private sector investment in the plantation sector was encouraged by the government through the provision of fiscal incentives for the conversion of rubber areas into oil palm estates and for the replanting of higher yielding rubber trees.

The introduction of the NEP in 1971 heralded the turning point in agricultural development strategies between 1970 and 1990. Firstly agricultural development was to be carried out within the two-pronged objectives of the NEP namely the eradication of poverty and the restructuring of society. However the main thrust had been poverty eradication - since the agricultural sector was characterized by low income and low productivity. Efforts to increase rural income and employment were concentrated on two main strategies; namely (a) the modernization of traditional small-scale agriculture through *in situ* development programmes and (b) the expansion of export crop production through the opening of new land settlements schemes. Whilst the former strategy aimed to intensify land-use and to diversify agriculture through replanting, land rehabilitation, improvement in infrastructural facilities and the provision of agricultural support services and incentives to small-holders, the latter involved the resettling of farmers in large-scale development schemes organized along plantation agricultural production but with ownership of individual holdings (of between 8 to 10 acres each) ultimately given to each settler

after a specified period of time. Large-scale cultivation of oil-palm, rubber and co-
coa were the main agricultural activities of the new land settlement schemes. The
main implementor of these schemes was the Federal Land Development Authority
(FELDA) which settled 53,000 families in 262 land development schemes in various
regions by the end of 1976. The provision of economic-sized holdings under the
new land development strategy had succeeded in raising the settlers' income above
the poverty line. In 1977, the average family income for settlers in FELDA rubber
and oil-palm schemes were M\$700 and M\$1500 per acre respectively.

In general, agricultural diversification has resulted in a significant change in the
composition of Malaysian agricultural exports. As shown in Table 4.4, the relative
importance of rubber as the main export revenue earner has declined considerably
from 55.1 per cent of total exports in 1960 to 3.8 per cent in 1990. In 1990, it was
overtaken by timber and palm oil which accounted for 8.9 per cent and 6.2 per
cent of gross exports respectively. Both commodities have emerged as new sources
of export revenue from the agricultural sector.

**Table 4.4 — Malaysia: Gross Exports of Major Agricultural
Commodities (1960-1990)– as % of Total Exports**

Agriculture	1960	1970	1980	1990
Rubber	55.1	33.3	16.4	3.8
Timber	5.3	16.5	14.1	8.9
Palm Oil	2.0	5.3	10.3	6.2
Other	3.7	4.0	2.8	3.4
% of Total Exports	66.1	59.2	43.6	22.3

Source: Bank Negara Annual Report (1990:Table 9.1)

However, investments in the agricultural sector have declined considerably in the 1980s largely because of the fall in international prices of agricultural commodities. The narrow profit margins are further aggravated by labour shortages in agriculture. As a consequence, the share of agriculture has been declining steadily from 32 per cent of the GDP in 1970 to 18.9 per cent in 1990.

4.4.2.2 Industrialization

Industrialization in Malaysia only began after independence. This is largely because the growth of local industries was effectively discouraged by the colonial policy which emphasised the export of primary commodities and the import of British manufactured goods. The post-independence move into manufacturing was considered a necessity not only as a sign of modernization and economic independence but also as a means of correcting the economic imbalance between extensive plantation agriculture and limited industrialization.¹⁴⁹

In general the Malaysian economy has undergone three phases of industrial development over the past three decades.

Phase 1: Import-Substitution (1958-1967)

The first step towards industrialization was the formation of import-substituting industries promoted by the government in the late 1950s. The policy was aimed at reducing the heavy dependence on imported consumer goods as well as to provide employment to the growing labour force. In order to overcome the deficiency in domestic capital and technical know-how a liberal policy was also undertaken to attract foreign investors. The government introduced the Pioneer Industries Ordi-

¹⁴⁹ Ariff 1985:14.

nance 1958 by which the establishment of new factories were directly or indirectly subsidized and protected by the government based on the infant-industry argument. The provision of infrastructural facilities, income tax reliefs, modest tariff protection and other incentives attracted foreign private investments. Many of the pioneer industries were newly established subsidiaries of British companies formerly exporters to the domestic market. Manufacturing activities were therefore concentrated on the production, assembly and packaging of previously imported consumer goods for the already established and captive home market.

The import-substitution strategy was quite successful in achieving its objectives in the first half of the 1960s. As observed by Osman-Rani¹⁵⁰; 'the strategy had made some contribution to the development process of the economy. It helped to diversify the economy, producing at least some move into manufacturing, and reduced somewhat the excessive dependence on imported goods. It utilized some domestic natural resources, created some employment opportunities, and contributed to economic growth.'

Nevertheless, various constraints related to the small domestic market slowed down the process of industrialization. By the end of the 1960s, the average growth rate had declined from over 11 per cent to 10 per cent per annum. Moreover its contribution towards the generation of employment fell below expectations where employment growth lagged considerably behind output growth. Since the import-substituting industries were based on imported raw materials or imported intermediate products the end result was a low ratio of value added to gross output and poor linkages effects with the rest of the economy¹⁵¹. As a result, even

¹⁵⁰ 1982:263.

¹⁵¹ Osman Rani: *ibid.*

though imports of consumer goods declined in the 1960s it was offset by a more than proportionate increase in the import of investment and intermediate goods. Import-substitution seemed to have aggravated rather than alleviated the country's dependence on imports. As the poor performance of the import-substitution policy became clearer the government began to undertake a strategic switch in emphasis at the end of the 1960s specifically from import-substitution to export-orientation.

Phase 2: Export-Orientation (1968-1985)

This marked the second phase of the industrialization process which gave a fresh impetus to industrial growth in Malaysia. This new policy was more consistent with the export-led growth strategy inherited from the colonial period and a new set of industrial legislation was enacted to attract and encourage the establishment of industries processing or manufacturing products for export.

The 1958 Ordinance was replaced with the Investment Incentive Act of 1968 which offered a wider range of incentives to industries producing for the export markets. Foreign investment was still encouraged but was geared to the NEP objective of restructuring society. Local participation in industrial enterprises was established through joint-ventures between state enterprises and foreign or local investors. One of the measures undertaken in this respect was the introduction of licensing procedures under the Industrial Coordination Act 1975 which required all large foreign firms with more than M\$250,000 shareholders' funds to allocate 51 per cent equity participation to Malaysians, out of which at least 30 per cent were to be held by Malay interest. Large local firms with similar shareholders' funds were also required to fulfill the 30 per cent Malay quota in terms of ownership and employment. Other, more liberal, incentives and concessions, still within

the scope of the NEP, were offered to promote export-oriented manufacturing activities. Tariff protection was increased for infant industries, longer tax holidays and tax concessions were offered to encourage labour-intensive industries, the use of local raw materials and the location of industries in areas allocated by the government such as the industrial estates and free trade zones. Export promotion by frequent overseas campaigns to attract foreign investments were encouraged by allowing deductions for export promotion expenses. A Malaysian Export Trade Centre was also opened in Kuala Lumpur to introduce products to importers.¹⁵²

A significant feature of this phase of industrial development is the dramatic growth of non-resource based industries producing textiles, electrical appliances and electronic goods for exports. The establishment of these industries was mainly attributed to the inflow of foreign investments since 1974. Capital investment was undertaken by large multinationals locating their operations in Malaysia to take advantage of the incentives offered by the government and the availability of relatively cheap labour.

Amongst the three industries, growth in the electronics industries was most significant. By 1979, Malaysia had become the world's largest producer of electronic chips and the third world's largest exporter after the United States and Japan. Besides contributing 38.4 per cent of total exports of manufactures in 1979, the other significant contribution of the electronics industry was in the generation of large-scale employment in the manufacturing sector. As methods of production were labour-intensive, the electronic companies became the most important absorber of low-skilled cheap labour in the free-trade zones. Between 1973-1979 employment in the electronics industry grew by 436 per cent. By 1979, these companies were

¹⁵² Osman-Rani 1982:266.

providing 72,800 jobs. Wages in this subsector have also risen to the average level for the manufacturing sector as a whole.

It is apparent that the set of policy instruments enacted by the government towards export-oriented industrialization in the 1970s had facilitated the expansion of foreign private investment and stimulated rapid industrial growth. Manufacturing accounted for 8.6 per cent of the GDP in 1960 but increased to 12.2 per cent in 1970 and further up to 17 per cent in 1980. Its share in gross exports also rose significantly from 11.9 per cent in 1970 to 21.6 per cent in 1980.

Phase 3: Industrial Diversification (1986 onwards)

Despite the rapid growth in industrialization, the manufacturing sector was still narrow-based as it entered the 1980s. About one-fifth of total production and over half of manufactured exports at the end of the 1970s were made up of electricals, electronics and textiles. Even though these industries were the main growth sectors, they were vulnerable to fluctuations in external demands as indicated by the fall in demand and the decline in private investments in these sectors during the recession of the mid-1980s. Industrial diversification was therefore necessary to broaden the industrial base and reduce dependence on the three traditional growth industries.

An attempt to broaden the industrial base was made in 1981 when the government established the Heavy Industries Corporation of Malaysia (HICOM) to initiate public sector involvement in heavy industries. The commitment to support heavy industries by the government was to emulate the experiences of Japan, Taiwan and South Korea; which indicated that a strong heavy industries sector was vital for the development of a successful newly industrializing economy. Among

the projects chosen to be implemented by HICOM, through joint-ventures with foreign investors, included the production of the national car, steel, cement, petrochemicals, transport equipment and shipbuilding. However, these projects have generally met with limited success because of many constraints. One of the main constraints was the costly investments required to finance these industries at a time of global recession. All of the heavy industries projects were financed either by foreign borrowings or foreign investment which adversely affected the balance of payments and fiscal debt problem. With the exception of the national car project which started production in 1985 the other industries were reviewed during the austerity drive between 1982-86; some were cancelled and others were delayed at the planning stage.

A more systematic approach towards industrial diversification was next undertaken with the publication of the Industrial Master Plan (IMP) in 1986. The IMP was produced as an indicative plan which suggested broad development strategies and objectives for sectoral manufacturing industries from 1986 to 1995.¹⁵³ In general, the Plan contains an appraisal of existing strategies, policy instruments and incentives and offers recommendations for the 12 industries that were examined under it.

Among the major problems affecting the Malaysian industrialization process as identified by the IMP were the lack of indigenous industrial technology, shortages of skilled and professional manpower, deficiencies in the existing industrial structure, inadequate private-sector initiatives and constraints imposed by the NEP objectives on restructuring.

The IMP however recommended that the non-resource based industries should

¹⁵³ Bank Negara Annual Report 1985:151.

continue to be the important sources of growth until 1995. The manufacture of electronic and electrical equipment was designated as priority industries. Development in both sectors is recommended to follow a phased approach by which the manufacture of consumer and simple industrial items is to be followed by the production of more complex and sophisticated products. Rationalization and modernization of the existing textiles was also proposed.

Further development in the resource-based industries was recommended to help improve the trade balance and promote linkages between sectors to maximize the country's comparative advantage. The priority industries designated in this sector are the tyre, palm-oil products, food-processing, wood-based products, petrochemicals, tin products and building materials industries.

The promotion of heavy industries was also considered vital by the IMP on the premise that these industries could lay a solid foundation for a more rapid and balanced growth which would help to accelerate the process of developing Malaysia into an industrial economy. Among the main recommendations for this sector were the rationalization of the existing shipbuilding and iron and steel plants, the production of the national car for the main segment of the domestic market and the emphasis on product technology (engineering design capability) in the machinery and engineering industry.

In line with the IMP several major policy changes were introduced in 1986 to boost private investment, especially foreign direct investment in the manufacturing sector. A new range of tax incentives was introduced through the enactment of the Promotion of Investment Act 1986 which replaced the 1968 Investment Incentives Act. In addition, the licensing procedure under the Industrial Coordination Act

1975 was liberalized by which only companies having M\$1 million in terms of shareholders' funds were required to obtain licences to engage in manufacturing activities. Another important measure which brought a sharp increase in foreign investments in 1988 and onwards was the liberalization of regulations for foreign equity participation. Under the new regulation owners of firms set up between 1986 and 1990 would be granted 100 per cent foreign ownership if they export more than 50 per cent of their products or employ 350 full-time Malaysian workers. The impact of the Promotion of Investments Act was reflected by the rise in foreign paid-up capital in government approved projects from M\$750 million in 1987 to M\$2 billion in 1988¹⁵⁴. Between 1986 and 1988, 20 per cent of total investment was foreign equity. As a result of the 'revival' of private investment, output growth in the manufacturing sector between 1986 and 1988 was registered at 12.7 per cent per year compared to the contraction of 3.8 per cent in 1985.

In summary, the manufacturing sector has undergone a process of rapid industrial diversification from the narrow base traditional growth industries to a wider range of industries producing resource-based to non-resource based consumer and intermediate goods and heavy industrial products mainly for the exports market and to a lesser extent the domestic market. With numerous government incentives and other factors that have governed export-led industrial performance since the 1970s private investment in the manufacturing sector is expected to play an important role of providing the impetus to the economic growth of Malaysia in the 1990s.

¹⁵⁴ Mid-Term Review of the Fifth Malaysia Plan:187.

4.4.3 The Achievement of the NEP

The year 1990 marked the end of the NEP and the First Outline Perspective Plan covering the period 1971-1990.

An assessment of the achievements of the NEP showed that not all of its targets had been met at the end of the twenty year period. One of the encouraging achievements of the NEP was the eradication of the overall incidence of poverty in Peninsular Malaysia from 49.3 per cent in 1970 to 15 per cent in 1990. However, despite the decline in the overall incidence of poverty, the gap in household income between and within the major ethnic groups remained wide. The Mid-Term Review of the Fifth Malaysia Plan showed that in 1987, the real mean income of the Chinese was 65 per cent higher than that of the *bumiputera*. Comparison by income categories also showed that the mean income of the top 20 per cent of *bumiputera* households were 40 per cent lower than that of the *non-bumiputera* in 1987. Inter-ethnic income disparity was also observed in the urban areas. The mean income of a *bumiputera* urban household was 32 per cent lower than the mean income of the *non-bumiputera* in 1987. Income inequality within group is also evident. Whilst the mean income of the *bumiputera* has increased from M\$172 in 1970 to M\$868 in 1987 the mean income of the middle 40 per cent was 11 per cent lower at M\$773; whilst the mean income of the bottom 40 per cent was 35 per cent lower than that of the average *bumiputera* in 1987.¹⁵⁵

In terms of the restructuring target, *bumiputera* employment was still under-represented in the commercial and industrial sectors. Instead, they were over-represented in the unskilled and low-paid jobs even though their representation in certain high-paid professional occupations such as accountants, engineers and

¹⁵⁵ Mid-Term Review of the Fifth Malaysia Plan 1989:40.

architects had increased from 22.2 per cent in 1985 to 29 per cent in 1990 which was close to the 30 per cent target of the NEP.¹⁵⁶ Restructuring of ownership in the corporate sector was, however, less successful. The estimated share of *bumiputera* share ownership, including trust agencies, was 20.3 per cent in 1990 which was 9.7 per cent short of the 30 per cent minimum target.

The performance in the creation of the Bumiputera Commercial and Industrial Community, measured by selected indicators also did not show encouraging results.¹⁵⁷ There was low progress in terms of creating viable *bumiputera* participation in the modern sectors of the economy largely due to their small and narrow-based business enterprises, inadequate experience and lack of management capabilities.¹⁵⁸ It was also argued that in addition to these factors, the recessionary climate of the first half of the 1980s had adversely affected the performance of *bumiputera* businesses. In 1986, 18 per cent of total non-performing loans valued at M\$200,000 or less each and 43 per cent of loans exceeding M\$500,000 were due from *bumiputera* enterprises.¹⁵⁹

4.4.4 The National Development Policy

Following the demise of the NEP the second outline perspective plan for the 1991-2000 period was formulated based on a new strategy called the National Development Policy (NDP). The main emphasis of the NDP is *growth with equity* to enable all Malaysians to participate in the mainstream of economic activities to ensure political stability and national unity. Among the main objectives of the NDP are (i) to attain a balanced development of the major sectors of the economy,

¹⁵⁶ The Sixth Malaysia Plan 1991:13.

¹⁵⁷ Mid-Term Review of the Fifth Malaysia Plan 1989:73

¹⁵⁸ The Sixth Malaysia Plan 1991:15.

¹⁵⁹ Mid-Term Review of the Fifth Malaysia Plan 1989:73.

(ii) to reduce and eliminate social and economic inequalities and (iii) to build a fully developed and industrialized nation with the ultimate goal of achieving national unity.

4.4.4.1 Growth and Structural Transformation

The NDP aims to achieve a rapid and sustainable economic growth of 7 per cent per annum in the nineties. Sectoral strategies will focus on further diversification of the economic base and the development of export-oriented and high value-added activities. Hence the manufacturing sector is envisaged to play an important role as the prime-mover of the economy. The primary strategy is to widen and deepen the industrial base which will lead to the production of higher value-added products, increased linkages with the small-medium sized industries and lessening dependence on the traditional growth industries.

Besides manufacturing, the services sector has also been identified as another generator of growth in terms of GDP, employment generation and the reduction of the large service trade deficit. Policy reforms and supportive investments will be undertaken to promote this sector as a leading rather than a lagging sector.

The share of agriculture in the GDP is expected to continue declining from 18.7 per cent in 1990 to 13.4 per cent in 2000. Manufacturing will play a leading source of growth; its share on the GDP is projected to grow from 27 per cent in 1990 to 37 per cent in 2000 and will account for 80 per cent of total merchandise exports.¹⁶⁰

¹⁶⁰ Mohd Kassim, M S 1991:161.

4.4.4.2 Distributional Strategies

In terms of income and wealth distribution, the NDP still maintains the basic strategies of the NEP to achieve the ultimate goal of national unity but with new dimensions.

Firstly, the anti-poverty strategy will shift its focus towards eradicating hard-core and relative poverty. It is envisaged that overall incidence of poverty will be reduced from 17.1 per cent in 1990 to 7.2 per cent in 2000. The incidence of hard-core poverty is expected to be eliminated in the process; the incidence of hard-core poverty is projected at 1 per cent in 2000.

In terms of restructuring the Malaysian society, the main emphasis is to increase the share and manpower quality of *bumiputera* in all levels of employments particularly in the high-paid professional, technical and managerial positions in the private sector. With regards to ownership in the corporate sector the original target of 30 per cent share ownership is to be maintained as a general rule but without any specific time frame for its achievement.

4.5 Conclusion

This chapter has outlined the socio-political and economic aspects of the Malaysian economy over the past three decades since independence as well as the direction of the economy in the nineties. It has also shown that the decade of the 1980s was a difficult and challenging period when structural adjustments had to conform to the impact of the economic recession. Since then there has been a distinct shift in development policy to promote the private sector and specifically the manufacturing sector as the main engines of growth in the 1990s. It is therefore

expected that the marketing strategies of financial institutions will be geared to cater for the growth of private investments and financing manufacturing industries.

Chapter V

The Malaysian Financial System

5.1 Introduction

The purpose of this chapter is to demonstrate how far the Malaysian financial system had developed when Islamic banking was introduced in 1983. It is envisaged that in a financial environment where both Islamic and traditional banks operate side by side the impact of Islamic banking is likely to be affected by the level of financial development in the traditional banking system. Its growth is likely to be moderated if there is a high degree of non-price competition from the conventional banks. Whilst the bank will undoubtedly have its own niche in the market, the task of mobilising deposits from a larger section of the population is more challenging in a well developed financial system where a range of more attractive financial instruments are available, a large network of traditional bank branches has been established and various types of specialized financial institutions have been set-up. In order to assess the performance of Islamic banking within the Malaysian financial system (in Chapter VII) this chapter will begin with an overview of the evolution of the Malaysian banking system and the development of the Malaysian financial structure until the end of the 1980s. The degree of financial monetization and financial deepening at the time when Bank Islam was established will also be outlined. Since the assessment of Bank Islam's performance in Chapter VII will also take into account the recessionary climate of the mid-1980s, the impact of the recession on the Malaysian banking system will also be examined.

5.2 Evolution of the Financial Structure

According to Thirwall (1976:20),

“a well-developed financial system has four main requisites, each of which can contribute to the process of financial deepening and to raising the level of savings. These four requisites comprise the monetization of the economy and the replacement of barter as a means of exchange; the establishment of a central bank; the development of a commercial banking system, and the development of a co-ordinated capital market.”

The fulfillment of all four requisites, according to Thirlwall, will create a well co-ordinated framework of financial intermediation which is important for the efficient allocation of capital between competing uses besides ensuring that saving is utilized for investment purposes.

It is evident that the development of the Malaysian financial system has also followed along this broad pattern of growth and development. The fulfilment of the first requisite; namely the monetisation of the economy can be traced as far back as the eighth century. The second requisite was realized when a Central Bank was established in 1959. This was followed by the development of the financial structure in which the commercial banks had developed into the largest and the most important group of financial institutions by the 1980s. Even though a well co-ordinated capital market has not yet been developed, rapid progress in the early stages of its development are already taking place.

5.2.1 Monetization of the Economy - Stage 1

The monetization of the Malaysian economy at its earliest stage of development

was largely attributed to the role of the port of Malacca as the halfway house for traders from India and West Asia on the trade route to China and the Far East in the eighth century. The use of copper cash was introduced by these traders to replace barter trade with the people of Malacca. Later indigenous tin cash was issued by the rulers of the Malaccan Empire in the fifteenth century. The occupation of Malacca by the Portuguese in 1511 and the Dutch in 1641 also brought into circulation a variety of silver and gold coins which facilitated trade not only in the Peninsular but throughout Southeast Asia.

Historically, the growth of a money economy in the Peninsular which subsequently stimulated the development of early banking and credit only began in the nineteenth century. The growth of the tin industry under British colonial rule added a new dimension to the country's external trade. The need for short-term credit to finance trade by the foreign tin mining companies led to the establishment of the first foreign commercial banks between 1859 and 1888. These banks, which were commonly known as 'exchange banks', concentrated mainly in the financing of external trade, involving primarily transactions in foreign exchange remittances between London, India and China, overdrafts, advances against shipping documents and trading in commercial bills.

The monetization of the modern economy developed rapidly in the 1920s as the growing tin industry was complemented by large-scale rubber planting to meet the growing demand for tyres in the mass production of motor cars in Europe. The boom in the prices of rubber and tin in the wake of rising world demand led to a thrive in domestic economic activity inviting new players into the banking business. These included Chinese businessmen who established their own banks in the late 1920s and the 1930s to meet the needs of the small entrepreneurs in

their close-knit communities. These Chinese banks were 'clannish' in character and each was designed to mainly serve a small client base. Bank lending was relatively conservative compared with the foreign banks. Money was borrowed and lent within each dialect community with a strong reliance on good faith and communal relationships rather than on tangible assets as security. Most of these banks lacked experience especially in foreign exchange dealings. They tended to hold large balances with the foreign banks because of the lack of lender of last resort facility. Nevertheless these banks played an important role in the monetization of the domestic economy by filling a gap in the credit market to cater for the smaller domestic businessmen who did not have sufficient access to the foreign banks.

The foreign and local commercial banks co-existed for the greater part of the first half of the twentieth century each serving a distinct clientele with little overlapping of functions. A greater share of the market was dominated by the foreign banks which formed part of an international network with close links with Singapore and London. The secondary financial market in Kuala Lumpur remained undeveloped, however. This was because almost one-third of exports from the Peninsula were channelled through the port of Singapore where an active foreign exchange market was developed.

Another significant feature of the financial system at this early stage of development was the establishment of a simple, stable and inexpensive monetary regime called the Currency Board to promote monetary stability within the region. The Board was accorded the sole right to issue a standard coin and currency note besides facilitating the growth of international trade. A series of legislative reforms were passed in the early twentieth century which finally led to the issue of a currency known as the Malayan Dollar in 1938 as the sole legal tender in Malaya,

Singapore, the British Borneo and Brunei.

A distinctive feature of the Currency Board was its high level of external reserves, held wholly in sterling balances and deposits, to back the currency. The backing by sterling reserves had two main advantages. First, the Malayan Dollar was pegged at the fixed rate of M\$1=2s. 4d. and was able to attract foreign investment into the tin-mining and rubber-plantation industries. Second, since sterling was a key currency it facilitated trade beyond the Sterling areas. In fact, in the 1950s Malaya was the highest US dollar exchange earner within the Sterling Area.¹⁶¹

Even though the Currency Board provided a stable and strong currency and facilitated British foreign investment and trade, it had certain disadvantages which restricted the internal stabilization management and long-term economic development of the country. Money supply was affected by the economic conditions and policies of other participating governments within the Sterling Area. Because of the openness of the economy, any changes in the export sector were automatically transmitted to the country's money supply via its external reserves. Money supply was determined primarily by the performance of the balance of payments and left little scope for discretionary monetary management to alleviate the effects of international trade on the domestic economy. By its nature, the Currency Board system also precluded any positive role in the promotion of economic development. In fact its minimum requirement of 80 per cent currency reserves backing had a high opportunity cost since these resources could have been deployed internally to finance economic development.

¹⁶¹ Chantrasmi et al 1982:288.

5.2.2 Establishment of the Central Bank - Stage 2

In 1954 a Mission from the World Bank recommended the formation of a Central Bank to fulfill the need for deliberate management of the monetary and credit situation of the country. Two years after independence, the Central bank of Malaya was established by ordinance in 1959.

The principal objectives of the Central Bank are;¹⁶²

1. to issue currency and keep reserves to safeguard the value of the currency.
2. to act as banker and financial adviser to the Government
3. to promote monetary stability and a sound financial structure and
4. to influence the credit situation to the advantage of the country.

To meet these objectives the Central Bank was vested with the power to regulate and supervise the financial system under the Central Bank of Malaya Ordinance 1958. By this ordinance the activities of all commercial banks in the country were brought under its supervision.

In terms of the first objective the Central Bank did not assume the power to issue its own currency until June 1967. The postponement of these powers was to allow for a gradual transition in the process of terminating currency links with the other participants of the Currency Board as well as to consider the possibility of establishing a common currency between them.

Following the formation of Malaysia which comprised the Malayan Peninsular, Singapore, Sabah and Sarawak in 1963, the Central Bank of Malaya was renamed

¹⁶² Bank Negara Malaysia 1989:98.

Bank Negara Malaysia (Central Bank of Malaysia). A year later, the Central Bank gave its legal notice to replace the Currency Board and entered into negotiations with Brunei to establish a common currency. In 1965, however, Singapore withdrew from Malaysia and regained its status as an independent participant of the Currency Board. This prompted further discussions, as a result of which all three participating governments decided to issue their own currencies while still maintaining interchangeability of currencies until 1973.

The new Malaysian currency, the Malaysian dollar, which was later renamed the *ringgit* in 1975, was issued by the Central Bank in 1967. Initially its value was maintained at par with the old Malayan dollar at 2s. 4d.. However, the autonomy of the Central Bank was demonstrated for the first time in November 1967 when it decided not to devalue the *ringgit* following the devaluation of the sterling. Whilst the old Malayan dollar was devalued with the sterling automatically the *ringgit* maintained its gold parity the result of which the Malayan dollar was equal to only 85.71 cents.¹⁶³

The currency interchangeability arrangements with Singapore and Brunei were terminated in May 1973. The 1958 Banking Ordinance was replaced by the Banking Act 1973 which provided the Central Bank with greater power to manage and supervise the banking system and other non-bank financial institutions which were closely linked to it. The Central Bank was also empowered to facilitate the financing of national development by fostering a development-oriented approach to banking.

Non-discriminatory and more liberal exchange control regulations were also introduced. This meant that exchange control regulations would be applied uni-

¹⁶³ One Malaysian dollar was equivalent to 100 cents. Similarly one ringgit is divided into 100 sen.

formly on all countries outside Malaysia and new regulations were made to liberalize payments into and out of the country. The joint-stock exchange of Malaysia and Singapore was also abolished and a separate stock exchange for Malaysia was set up in Kuala Lumpur.

Following the uncertainty of the international foreign exchange markets and the instability of the U.S. dollar the Central Bank adopted a floating exchange rate system in June 1973. Under this new system the Central Bank was no longer bound to buy U.S dollars at the designated floor rate and the Malaysian dollar was allowed to float upwards. With the floating of the *ringgit*, banks in Malaysia were free to determine their own exchange rates in respect of any foreign currency. In 1975, Malaysia adopted the 'dirty float' by which the value of the ringgit was not determined solely by the U.S dollar but was tied to a basket of selected currencies of countries which were significant trading partners of Malaysia. With these changes the inter-bank foreign exchange market in Kuala Lumpur has expanded rapidly since 1973.

5.2.3 Development of the Financial Structure - Stage 3

One of the first priorities following the establishment of the Central Bank was to develop an indigenous banking system - a precondition for effective monetary management; and the establishment of special development financial institutions to facilitate the financing of economic development.

5.2.3.1 The Banking System

(i) The Commercial Banks

At the outset, the task of building the basic structure of the banking sys-

tem involved 'the development of a Malaysian-oriented banking structure, based on a wide network of domestic banks established on sound banking lines and the reorientation of the operations of the foreign banks towards meeting Malaysian needs.'¹⁶⁴ Between 1960 and 1967, the Central Bank concentrated on encouraging the establishment of Malaysian incorporated banks. This institution-building policy was actively pursued. In 1960 two new commercial banks¹⁶⁵ were established with full Malaysian equity participation. This was followed by the establishment of another domestic commercial bank¹⁶⁶ in 1966; this time with full government ownership.

The impact of the indigenization policy was noticeable even as early as the first half of the 1960s. There were 8 domestic banks with 12 branches in 1959. By 1962, three years after the establishment of the Central Bank, the number of domestic banks had increased by three but their branch offices had multiplied to 91. By the end of 1967 the domestic banks had doubled to 16 with 161 branches. In contrast, only three new foreign banks were established during the 10 year period. The number of domestic bank branches had exceeded the 151 foreign bank branches. This was mainly attributed to the Central Bank regulation which disallowed the establishment of new foreign bank branches from 1966. The rapid increase in the branch network had decreased the number of persons per branch office by more than half from 71,600 persons in 1959 to 32,300 persons in 1967.

¹⁶⁴ Bank Negara Malaysia 1989:42.

¹⁶⁵ Malayan Banking Berhad and UMBC.

¹⁶⁶ Bank Bumiputera Malaysia Berhad.

Table 5.1 — Commercial Banks: Selected Data

	1959	1967	% change
Total number of banks	26	37	42.3
Domestic banks	8	16	100.0
Foreign banks	18	21	16.7
Branch Network	111	314	182.9
Domestic banks	12	163	1258.0
Foreign banks	99	151	52.5
Persons served per office	71,600	32,300	-54.9
Total Deposits(M\$million)	818	2237	173.5
Demand Deposits	465.7	791.8	70.0
Fixed Deposits	258.7	1011.8	291.0
Savings Deposits	93.6	434.0	363.7

Source: Bank Negara Malaysia (1989: Table 6.1)

The supply-leading process of institution-building and the spread of branches both in the urban and rural areas resulted in rapid increases in the percentage of deposits mobilized. Total commercial bank deposits increased by 173.5 per cent during the period from M\$818.0 million in 1959 to M\$2,237.6 at the end of 1967. (see Table 5.1). Demand deposits grew by 70 per cent but there was even greater growth of fixed and savings deposits (291%, 363% respectively).

By the 'Malaysianization' policy the Central Bank also encouraged the transformation of the banking system's holding of sterling assets into Malaysian assets and balances. Instead of accumulating their funds in external reserves, as commonly required during the Currency Board period, domestic banks were encouraged to invest in domestic assets by channelling their financial resources into loans

and advances; and investment in Malaysian public and private securities. As a result, there was a significant change in the composition of the uses of funds in the banking system. By the end of 1967 less than 10 per cent of total resources in the banking system were held abroad compared to 40 per cent in 1959. The proportion of bank resources held in the form of loans and advances also increased from one-third in 1959 to 46 per cent at the end of 1967.

Throughout the 1970s and 1980s many significant changes have occurred in the structure of commercial banking in Malaysia. Commercial banks have moved into diversified holding companies with subsidiaries engaged in the activities of finance companies and merchant banking. Since 1986 commercial banks have also entered the stockbroking business. Three of these banks were granted stockbroking licences in 1987 and another had acquired shares in an existing stockbroking firm.

The development in commercial banking is also marked by the introduction of computer technology since 1973 which has increased the speed and accuracy of transactions. Computerisation has facilitated the calculation of interest-rate on savings deposits on a daily basis, the installation of ATM networks for convenience-banking, automated cheque clearing system and the opportunity to have direct business links with the world financial market through the SWIFT (Society for Worldwide Interbank Financial Telecommunications) facility. By the end of 1987, 36 of the 38 commercial banks had computerised their operations. The ATM services have also expanded rapidly since the first ATM was installed in 1981. By the end of 1987 eighteen commercial banks offered ATM services through 609 ATM points with a card-base of 1.6 million.

Despite the growing importance of the locally-incorporated commercial banks

in the market, the international banks still control a considerable size of the market as shown in Table 5.2.

Table 5.2 — Market Share: Foreign Banks, 31 December 1990

	M\$ million	% share
Deposits	20,366	24.7
Loans	21,285	26.4
Branches	146	14.6
ATM	178	15.0

Source: Bank Negara Annual Report 1990

There were 16 foreign banks and 29 foreign bank representative offices at the end of 1990. A few of the foreign banks also have minority equity shares in several domestic banks.

(ii) The Finance Companies

The second group of financial institutions within the Malaysian banking system is the finance companies. These are deposit-taking institutions primarily engaged in money-lending activities by providing loans for the purchase of consumer durables; mainly motor vehicles on hire-purchase terms. Other forms of credit offered include housing and personal loans, bridging finance, refinancing, factoring, leasing and other types of commercial lending. These companies are not allowed to accept demand deposits; hence their main sources of funds comprise fixed and savings deposits mobilized from the public. They tend to charge higher rates on loans than the commercial banks but offer higher interest rates on their deposits. The growth of these finance companies had begun in the early 1960s as wholly-owned

subsidiaries of the commercial banks. By 1969, there were 25 finance companies with 130 branches. In order to regulate the operations of these companies, in the interest of depositors and to strengthen the financial system, the Central Bank extended its powers of supervision to this group. The Finance Companies Act 1969 was enforced which brought the licensed finance companies under the supervision of the Central Bank.

(iii) The Merchant Banks

The basic structure of the banking system was complete when the Central Bank approved the first merchant bank in 1970. Merchant banks are specialized banks which cater for the financial needs of the corporate sector. Their fee-based services include a full range of specialized services relating to all aspects of corporate finance and corporate advisory services such as the underwriting of share issues, acting as share registrar, corporate advice on restructuring, mergers and acquisitions; promotion of new investment and joint ventures; and the undertaking of feasibility studies. Investment advice (namely portfolio management, the establishment and management of investment and unit trusts; and custodian and nominee services) and banking intermediation services (such as the management of syndicated loans, and the provision of acceptances and guarantees)¹⁶⁷ are also provided for fees. Merchant banks also engage in fund-based operations such as accepting call and fixed deposits, extending loans to clients, money-market operations and related banking functions including leasing finance, bridging finance, discounting and rediscounting, factoring and participation in syndicated loans. The combination of fee-based and fund-based services are essential for the effective "full service" merchant bank. The emergence of the merchant banks in the

¹⁶⁷ Bank Negara Malaysia (1989:224).

1970s was considered timely because it coincided with the growth of the corporate sector under the export-oriented industrialization policy and the restructuring strategy of the NEP. To ensure that the merchant banks play their specialized role in development and corporate financing these banks were required to derive at least 30 per cent of their income from fee-based services. There are 12 merchant banks in operation and because of the small market the establishment of new merchant banks has not been permitted since 1976.

- **Significant Policy Changes in the 1980s**

- (a) Interest Rate Policy**

One of the significant features of the banking industry since the late 1970s is the increased competition between the commercial banks and between the commercial banks and finance companies especially in retail banking to the advantage of both savers and borrowers. This is largely attributed to the evolution of a market-oriented system of monetary management adopted by the Central Bank. One of the measures undertaken by the Central Bank in this direction was a shift from the system of administered interest rate determination for the commercial banks to one that responded efficiently to changing market conditions in 1978. Whilst interest rates on deposits with finance companies had been freed from regulation since 1973, the new liberalization allowed commercial banks to fix their own rates of interest on deposits and the lending rate charged to their prime customers for loans and advances. However, the maximum interest rates charged on loans to priority sectors namely the *bumiputera* borrowers, small-scale enterprises and individual house buyers continued to be regulated by the Central Bank. However in response to the downwards rigidity of lending rates with falling interest-rates,

the commercial banks were required to anchor all borrowing rates, except those for the priority sectors, to their own declared base-lending rate (BLR) since 1983. The BLR is the lending rate quoted based on the banks' cost of funds, after provisions for liquidity requirements and overhead costs. Based on the BLR the interest margin charged on each loan is to be based on the customers' credit standing, nature of project to be financed, repayment schedule and collateral offered. The new system was further refined in 1987 so that the interest margin should not exceed the BLR by more than 4 percentage points depending on the credit standing of each borrower. Commercial banks were also allowed to charge a penalty rate of up to 1 per cent of the loan instalments in default.

(b) Single Customer Credit Limit

To prevent the overconcentration of loans in one particular sector or to a single customer, maximum limits were set by the Central Bank in 1984. The overall limit for large loans (which exceeds 15% of the bank's capital funds or working capital) were set at 50 per cent of total credit facilities. The maximum limit for loans to any single customer or sector was also set at 30 per cent of a bank's capital funds in the case of domestic banks and 30 per cent of net working funds for the foreign banks.

(c) Capital Adequacy Requirements

Another prudential measure is the capital adequacy requirements (CAR) which commercial banks are required to observe. Between 1982-88, each domestic bank was required to maintain a minimum 'free' capital ratio of 4 per cent against its total assets in Malaysia (less long-term investments). Free capital is defined as the shareholders' funds less fixed assets and long-term investments. The CAR

was meant to serve as a cushion against unforeseen losses arising from banking activities, to restrain overly rapid and imprudent growth and to protect depositors from the 'moral hazard' of bank managers who undertake high-risk projects which cost more than could be covered by available capital. In 1988, a new CAR was introduced following the Basle Capital Accord which harmonizes capital standards internationally. By the new framework, each category of assets is weighted according to its perceived level of risk and the adequacy of capital will be assessed on this risk-adjusted basis. All domestic financial institutions were expected to comply with a minimum risk-weighted capital ratio of 8 per cent by 1992.

(d) The Banking and Institution Act (BAFIA) 1989

In view of the rapid growth and the growing competition in the banking system and the blurring of the lines of business between the commercial banks, finance companies and merchant banks, the BAFIA was introduced on 1 October 1989 to provide for an integrated supervision of the Malaysian financial system, and to streamline and modernise the laws relating to banking and all other financial institutions.¹⁶⁸ Under this new Act¹⁶⁹ the Central Bank is given a wider power of supervision over all major bank and non-bank financial institutions except those in the capital market. Foreign banks are also required to incorporate locally by 1994.

5.2.3.2 Development Finance Institutions

The second priority in the development of the financial structure since 1960 was the establishment of development finance institutions with special roles to

¹⁶⁸ Bank Negara Annual Report 1989:45.

¹⁶⁹ This Act replaces the Banking Act 1973 and the Finance Companies Act 1969. The Islamic Banking Act is not affected.

play in financing the development of specific sectors in the economy.. The country's first development bank called the **Malaysian Industrial Development Finance Limited (MIDF)** was set up in 1960 corresponding to the beginning of industrialization in 1958. The bank was formed with equity participation from the Federal Government, the Commonwealth Development Corporations, the commercial banks and insurance companies. Its principal role is to provide financial assistance to private industrial enterprises, factory mortgage loans and hire-purchase activities. It also operates to mobilize industrial capital in the form of equity participation and to provide assistance for the underwriting and flotation of share issues. These activities are funded by its main sources of funds namely its paid-up capital and long-term loans from the Government and from domestic or foreign financial institutions.

The **Agricultural Bank of Malaysia** was set up in 1969 to promote sound agricultural development in the country. Its main function under the NEP was to coordinate the flow of funds from the various public sector agencies¹⁷⁰ to farmers, smallholders and fishermen for agricultural development. Its initial focus was on providing short-term production credit needs to farmers in the major rice growing areas. Since then it has expanded its loan facilities to small farmers in other agricultural sectors to achieve the NEP target of eradicating poverty. Besides its shareholders' fund the principal source of funds of the bank comprised fixed, giro and savings deposits. The fixed and savings deposit schemes were introduced in 1972 to encourage the savings habit especially amongst the rural population as well as to mobilize financial resources for its loan operations. Generally, interest rates paid on its deposits are higher than the rates offered by the commercial banks.

¹⁷⁰ There were at least ten agencies providing agricultural support services under the NEP to farmers and small-holders such as subsidies, credit, extension, marketing and processing.

The interest rates on loans tended to change from time to time to be in line with the national policy on poverty eradication and economic development. Between 1969 and 1985, small loans of less than M\$30,000 extended for poverty eradication projects were not charged any interest. Loans to *bumiputera* enterprises under the restructuring objective of the NEP, not exceeding M\$50,000 were charged 2 per cent interest per annum. However, all loans approved for the two NEP objectives were charged a concessionary rate of 4 per cent since 1986.

To promote *bumiputera* equity participation in commerce and industry under the NEP, the **Development Bank Malaysia** was incorporated in 1973 as a wholly-owned subsidiary of the Government-owned commercial bank, Bank Bumiputera Malaysia Berhad (BBMB). Its operation includes the provision of medium and long-term loans to finance the purchase of fixed assets in approved projects, for equity participation in commercially viable projects and for the provision of guarantees for industrial equipment loans to *bumiputera* industrialists. The bank also provides technical, managerial and consultancy services for the planning and implementation of projects. Its principal sources of funds are made up of its paid-up capital, long-term borrowings from the Federal Government and fixed deposits from government agencies. The bulk of its loans at the end of 1987 was channelled into the financing of manufacturing activities and the interest rates charged on these loans vary between 6 per cent and 11 per cent per annum. One of the unique features of the bank is the provision of short-term financing based on the Islamic principle of *musharakah* in 1983 which was directed mainly to the construction sector for property development. It was reported¹⁷¹ that one of the projects under this scheme gave the bank a profit three times higher than what it would have

¹⁷¹ Man 1991:249.

earned under the interest-based system.

One of the steps undertaken by the government to support its policy of industrial diversification in the early 1980s was the establishment of the **Industrial Bank of Malaysia** in 1979. The objective of the bank is to promote and assist in the expansion of productive capacity in capital intensive and high-technology industries; in particular the export-oriented industries and heavy industries such as ship-building and engineering. In 1986, the bank introduced its export financing facility which provides long-term credit facilities to industries exporting capital goods. It also participated in the New Investment Fund scheme to revive domestic economic activity after the recession by giving credit priorities to the manufacturing sector. In the same year the bank was also allowed to participate in the Islamic Development Bank's foreign trade financing (FTF) scheme which provided guarantee facilities to Malaysian manufacturers for the import of selected raw materials. The resources of the bank comprise mainly term loans and its shareholders' funds. In 1987, the interest charged on its loans varied according to the type, ranging from 4.5 to 9.5 per cent per annum.

5.2.3.3 Savings Institutions

Apart from the commercial banks and finance companies the **National Savings Bank** and the **co-operative societies** are the main deposit-taking institutions in the financial systems whose main functions are to mobilize savings among the middle and lower income groups. Both types of institution have their own niches in the market; the National Savings Bank is readily accessible to the small savers, especially the low income group and those in areas not adequately served by the commercial banks and finance companies. The co-operatives societies also

mobilize small savings from their members in various sectors of the economy.

The establishment of the National Savings Bank in 1974 was a consequence of the reorganization of the Post Office Savings Bank which had been relatively successful in the mobilization of savings up to 1960 but later failed to compete with the newly established commercial banks and finance companies. By the end of 1973 only 27 per cent of total savings deposits were kept in the Post Office Savings Bank compared to 70 per cent in the commercial banks. Among the changes introduced by the new savings bank is a wider range of savings instruments for encouraging savings such as the Premium Savings Certificate Scheme which gives handsome bonus prizes, the Fixed Deposits Scheme with tax-free interest incentives and the Save-As-You-Earn scheme. On the asset side, the National Savings Bank is obliged to hold a certain percentage of its investments in government securities in order to achieve its developmental objectives. Until 1984 it was one of the important holders of public debt where at least 70 per cent of its investments were held in government securities.

Generally, co-operative societies are not financial intermediaries and until 1986 did not come under the supervision of the Central Bank. However many co-operatives in Malaysia collect deposits under the legal loop-hole that co-operatives were permitted to take deposits through share subscription from their members. These deposits are then deployed as loans to members or to finance the business activities. The largest co-operatives are the urban credit co-operative societies which mobilize savings from fixed income members and in turn provide them with small loans at reasonable cost. The most popular of these urban credit co-operatives in the 1980s were the deposit-taking co-operatives (DTC) which expanded rapidly by offering high interest rates on deposits exceeding those prevailing in the banking

system, opening branches throughout the country and embarking on large scale financing and investment activities. By 1986 there were 35 DTCs with 685 branches, a total membership of 1.05 million and deposits of M\$4 billion. Nevertheless many of these DTCs were poorly managed and in some cases lacked prudent and honest management. The first sign of financial crisis amongst the DTCs occurred in 1985 when a large DTC failed to meet deposit withdrawals. This created a major shock to the financial system when a series of runs spread through contagion to the other DTCs and even affected the finance companies due to depositors' nervousness. The Central Bank had to intervene and with the promulgation of the Essential (Protection of Depositors) Regulations 1986 the DTCs were brought under the supervision of the Central Bank. The assets of 24 DTCs were suspended and their activities investigated.

5.2.3.4 Other Financial Intermediaries

Another extension to the Malaysian financial system is a group of intermediaries which complement and supplement the activities of the major financial institutions. These include the housing credit institutions which operate on a much smaller scale than the banks and the deposit-taking institutions. Other financial institutions designed to mobilize the savings of the *bumiputera* community and to promote their equity ownership in the commercial and industrial sectors also come under this group.

(i) Housing Credit Institutions

The importance of the housing credit institutions reflects the government policy of promoting home-ownership since 1970. Whilst the commercial banks represent the largest single source of housing credit in the country, the second major source

of housing credit for the middle and higher income group in Peninsular Malaysia is the Malaysia Building Society followed by the Housing Loans Division of the Treasury which provides housing credit to employees in the public sector. The Malaysia Building Society was the pioneer institution in the private sector specialising in housing finance. It was established in 1950 as a wholly-owned subsidiary of the Commonwealth Development Corporation at a time when very little housing credit can be obtained from the commercial banks which preferred to concentrate on trade financing and the financing the manufacturing sector. It became a public quoted company in 1963. The major source of funds of the company are derived from its shareholders' funds and long-term debentures from the Employees Provident Funds. The role of the Society as the leading housing credit institution gained additional significance in 1976 when it was appointed to manage a new housing loan scheme to promote ownership of low-cost housing amongst the low income group. Under this scheme borrowers earning less than M\$500 were eligible for loans of up to 90 per cent of the value of the houses, inclusive of land costing not more than M\$25,000 each. The remaining 10 per cent end-financing could be obtained either from the Employees Provident Fund or the commercial banks and finance companies. In 1985 the government introduced another low-cost housing loan scheme called the Special Low-Cost Housing Programme (SLHP). It is an accelerated programme which required the commercial banks and finance companies to make firm commitment to provide end-financing to at least 60,000 units of low-cost houses costing M\$25,000 or less each between 1986-88. The aim of the programme was to utilize idle capacity in the construction and manufacturing sectors especially cement, steel, building materials and labour. In general, the interest rates charged by the commercial banks were set at a ceiling rate of 10 per cent, while the interest rates of the Society tend to vary between 8.25 per cent to

10 per cent depending on the amount of loans approved for different categories of property. With the implementation of the SLHP the maturity periods of housing loans had lengthened significantly from an average of 10-15 years to 20-25 years.

(ii) National Mortgage Corporation (Cagamas)

Because of the long maturity period of each loan and the maximum ceiling interest rates on loans under the SLHP the banking system and the building societies faced a growing risk of liquidity problems and an interest-rate risk. This was because the bulk of deposits in the banking system had maturity periods of less than 18 months which implied that the banks faced the risks implicit in borrowing short and lending long. At the same time the banks also faced the real possibility of their cost of funds rising above 10 per cent per annum during the tenure of the housing loans. To eliminate both the liquidity and interest rate risks a secondary mortgage market was created in 1987. The national mortgage corporation, Cagamas Berhad, was incorporated in 1986 for this purpose with equity participation from the Central Bank, the commercial banks, the finance companies and the merchant banks. With a M\$500 million advance from the Central Bank the initial role of Cagamas Berhad was to purchase the existing housing loans from the primary lenders, repackage these loans into bearer fixed-rate bonds and then issue these securities for sale in the capital market to long-term investors. By selling the housing loans to Cagamas the primary lenders can obtain new sources of funds which not only reduced the above risks but also provided finance to new loans and investments.

(iii) Tabung Haji

In the context of this study it would be relevant to describe two other in-

stitutions which have been specially established for the economic development of the *bumiputera*/ Muslim community. The first is the Pilgrims Management and Fund Board or *Tabung Haji* which serves two functions - as a financial institution and as a pilgrims' management body. The Board which was established as a merger between the Pilgrims Savings Corporation and the Pilgrims Affairs Office by statute in 1969 originally began as a voluntary initiative to enable intending pilgrims to institutionalize their savings for the purpose of performing their *hajj* or pilgrimage to Makkah. Prior to that, pilgrims without sufficient savings tended to sell all their properties to finance their *hajj* and as a result many faced dire economic consequences upon their return. As the commercial banks and other savings institutions were unacceptable to prospective pilgrims because of the presence of interest *Tabung Haji* was formed to mobilize savings on the basis of profit not interest. *Tabung Haji* not only accepts deposits from prospective pilgrims but also manages their transportation and general welfare during the *hajj*. Deposits are accepted through the post-offices, direct counter collections and monthly salary deductions. Funds derived from the accumulation of savings are invested in Islamically legitimate investments and profits are distributed among the depositors in the form of bonus after *zakat* deductions. Nearly one-half of the investments have been taken in the form of equity participation in public-listed manufacturing companies. Through these share investments *Tabung Haji* acts as an instrument to increase *Muslim* equity participation in share ownership. The *Tabung Haji* has grown enormously in terms of total resources, volume of deposits and the number of depositors. Its total resources have multiplied from M\$12.9 million in 1969 to M\$971 million at the end of 1988. The number of depositors has also increased tremendously from 7,000 in 1969 to more than 450,000 in 1988. At the same time the size of its deposits amounted to M\$790 million compared to M\$7 million in

1969.

(iv) The National Unit Trust Scheme (ASN)

It is generally agreed that the most significant financial intermediary that has been established to achieve the NEP objective of securing 30 per cent ownership by the *bumiputera* community in the corporate sector is the National Unit Trust Berhad (Amanah Saham Nasional Berhad or ASNB). The ASNB was set up in 1979 as a wholly-owned subsidiary of the Perbadanan Nasional Berhad (PNB) which in turn is the subsidiary of the Bumiputera Investment Foundation.

As a unit trust the function of the ASNB is to serve as a medium through which small individual *bumiputera* investors can acquire a share of the portfolio of investments under the National Unit Trust Scheme or popularly known in Malaysia as the ASN scheme. The investor is known as the unit-holder who does not actually hold shares directly in limited companies but rather owns units which form a share in a portfolio of investments owned by ASNB. All *bumiputera* individuals as young as 18 years old are eligible to become a unit-holder under the ASN scheme. A unit-holder is allowed to own a minimum of 100 units and a maximum of 50,000 units. However unit-holders who cannot afford to buy the minimum 100 units in one purchase are allowed an initial purchase of the first 10 units at M\$1 each. The purchase of the next 90 units need not be paid in cash but can be done by crediting the dividends declared on the basic investment of 100 units. To ensure that each unit-holder would own at least 100 units under the Scheme until 1990, the small saver was not permitted to sell this basic 100 units until that year. Hence by 1990 each ASN unit would be guaranteed at par value of M\$1, irrespective of any change in the market value of the portfolio of shares held by the Scheme.

It is worth noting that the unit-holders were guaranteed dividends of at least 10 per cent per annum until 1990 based on the fact that the portfolio investments of the Scheme comprised largely the shares of blue-chip companies purchased by ASNB from PNB. Nevertheless since its inception in 1981, the dividends paid had exceeded 10 per cent per annum except in 1987 when a 9 per cent dividend was paid because of poor corporate performance. Incentives have also been offered to attract greater participation such as the issue of a bonus of one unit for certain units held and special credit facilities from commercial banks to finance the purchase of additional units. After 1990, the portfolio of investments held by the Scheme was listed on the Kuala Lumpur Stock Exchange. The ASN units now have a market value and these units can be transacted but only directly with the Scheme to ensure that ownership would remain within the *bumiputera* community. Despite the novel principle on which the ASN Scheme operates, only 44.8 per cent of an estimated 5.09 million eligible members of the *bumiputera* community had participated in the scheme by the end of 1987. Public opinion indicates that one of the main reasons for the large percentage of non-participation is the fact that the investment portfolio of the ASNB includes interest-based financial institutions. Nevertheless the ASN scheme had become an important vehicle for mobilising the savings of the *bumiputera* community and in achieving the 30 per cent equity ownership in the industrial and commercial sector by 1990.

5.2.3.5 Development of the Money Markets

Overlapping the policy of institution-building in the banking system is the development of the money market to facilitate secondary transactions for short-term funds. The basic structure of the money market has developed since the establishment of the Central Bank in 1959. Clearing houses were set up in Kuala Lumpur

and Penang in 1960 to facilitate the clearing of cheques among the commercial banks. The first discount house was established in 1963 to assist the intermediation of short-term bills; backed by the lender of last resort facilities by the Central Bank. The Stock Exchange of Malaya and Singapore was established in 1962¹⁷² to promote a capital market under the guidance of the Central Bank. The issuance of Treasury bills by the Central Bank on behalf of the Government as instruments of monetary management took place in 1964. A more active secondary market began to develop with the introduction of a range of securities with varying maturities, different interest rates and terms of redemption to meet the investment needs of various investors.

With the rapid growth of the domestic economy in the late 1970s as reflected by the boom in the prices of primary commodities and manufactured goods, there was increasing demand for new financial instruments and investment opportunities for the financial system to match the higher levels of savings. The limited supply of Treasury bills and other maturing government securities was not sufficient to meet the growing and diverse needs of investors. Two new papers were therefore introduced by the Central Bank in 1979 to further develop the money market and increase the efficiency in the mobilization of private savings. These were the bankers acceptances and negotiable certificates of deposit.

With the introduction of these two new financial instruments, the usage of repurchase agreements (Repo) transactions increased significantly in the 1980s especially when interest rates were low and liquidity was in excess during the recession. A Repo transaction is a short-term deposit or loan backed by a collateral

¹⁷² The Kuala Lumpur Stock Exchange was set up in 1973 following the termination of the currency interchangeability arrangements with Singapore.

of securities that can be traded in the secondary market. It involves a borrower who needs very short-term funds and an investor with surplus funds to spare. In a typical Repo transaction, a borrower A and an investor B may enter an overnight Repo agreement for M\$10 million at the going rate of 5 per cent per annum. A would receive M\$10 million in cash from B and issue Malaysian government securities worth M\$10 million as collateral to B. On the following day, B pays the principle sum of M\$10 million plus interest amounting to M\$1,370 and returns the securities to A. As a Repo instrument, a bankers acceptance (BA) is a negotiable bill of exchange drawn and accepted by a commercial bank or a merchant bank for the purpose of facilitating trade financing by importers, exporters, buyers or suppliers. It can only be drawn for short-term trade financing of up to 200 days and are payable in multiples of a thousand ringgit, with a minimum denomination of M\$30,000. On the other hand, a negotiable certificate of deposit (NCD) is a receipt for a fixed or time deposit placed with a commercial bank. Unlike the receipt for ordinary time deposits the NCD is negotiable or transferable. The name of the depositor is not written on the NCD and the principal sum of the deposit would be paid on the date of maturity by the issuing bank to whoever is the bearer of the NCD on that date.

The initial response of the corporate sector towards the BAs was relatively more positive than for the NCDs. The last resort facility provided by the Central Bank on the BAs promoted public confidence and the requirement that BAs must be discounted at least once in the secondary market before qualifying for rediscounting with the Central Bank had also resulted in active trading of BAs compared to the NCDs. The NCDs were initially less popular partly because of the higher interest paid on fixed deposits in 1979. It seemed that more weight was attached to high

interest than to liquidity (which could be resolved by the traditional overdraft). Nevertheless the volume of NCDs has grown significantly especially when interest rates on fixed deposits dropped sharply in 1987. During such period of excess liquidity business enterprises found it more profitable to park their surplus funds in the form of NCDs. To promote active trading in the secondary market for NCDs, merchant banks with a minimum capital of M\$30 million each were granted permission to issue their own NCDs in 1987 followed by the finance companies with the same capital base in 1990. By 1988, three other new instruments were traded in the money market namely the interest-free Malaysian Government Investment Certificates, the mortgaged-backed Cagamas bonds and the Floating Rate NCDs.

- **Financial Deepening**

The availability of a wider range of financial instruments had added depth to the financial market as the accumulation of financial assets continues to increase at a faster pace than the accumulation of non-financial wealth or the GNP. At the time Islamic banking was introduced in Malaysia in 1983, the ratio of broad money supply (M2)¹⁷³ to GNP at current prices was 0.64; by 1989 it had increased to 0.71. Both ratios are relatively higher than that of the other Southeast Asian countries with the exception of Singapore which recorded higher ratios of 0.73 in 1982 and 0.91 in 1989. A study by the Central Bank¹⁷⁴ shows that the M2/GNP ratio has been relatively more stable in developed economies including Singapore compared to Malaysia which reflects a more rapid process of monetization in Malaysia. The degree of monetisation of the Malaysian economy may also be reflected in the holdings of broad money, M2 per capita. In 1982, M2 per capita was US\$1,091

¹⁷³ comprising currency and all deposits with the major financial institutions.

¹⁷⁴ Occasional Paper No.1 July 1984.

and has risen to US\$1,600 in 1989. In terms of the maturity structure of deposits and the length of bank loans it is evident that there has been an increase in the share of longer-term deposits of more than one year in maturity. In 1970, 82.8 per cent of total private sector deposits were in the form of short-term deposits (mainly demand and savings deposits). By 1983, their share has fallen to 63.4 per cent compared to the increase of longer term deposits to 17.3 per cent. By the end of 1990, demand deposits accounted for 15.8 per cent of total deposits mobilized, savings deposits accounted for 16.2 per cent whilst the bulk was held in fixed deposits which accounted for 68 per cent of total deposits mobilized by the banking system. A similar trend has also been noticed in the length of loans and advances. Whilst short-term loans of one year or less accounted for 71.9 per cent of total loans in 1970 and 43.7 per cent in 1983, the proportion of long-term loans of more than four years in maturity has been on the upward trend from 16.6 per cent in 1970 to 38.6 per cent in 1983 and 60 per cent in 1990. The above indicators show that the Malaysian banking system had reached the stage of considerable maturity when Bank Islam was incorporated in 1983.

5.2.4 Capital Market Development - Stage 4

The fourth and last requisite for a developed financial system envisaged by Thirlwall as stated at the beginning of this chapter is a well-coordinated capital market. The capital market in Malaysia is relatively small and undeveloped compared to the money and foreign exchange markets. Nevertheless the development of an effective capital market is one of the major objectives of financial development in Malaysia as is the case in other developing countries.

The Malaysian capital market consists of a primary securities market which

deals in the issue of new government and corporate securities and a secondary market in which existing securities are being traded. The instruments in the capital market include all public and private debt securities with maturities exceeding one year, corporate stocks and shares with no fixed maturities and commodity futures. The largest component of primary funds raised is through the issue of government securities. Even though the primary issue of corporate stock and shares is relatively small, it has expanded rapidly since the 1960s. The bulk of secondary transactions in the Kuala Lumpur Stock Exchange, is in corporate securities. This may be attributed to the fact that secondary transactions of Malaysian government securities (MGS) are conducted mainly in the money market and also because a majority of MGS are held by non-bank financial institutions such as the provident fund which tend to hold these securities until maturity.

The latest development in the Malaysian capital market is the rapid growth of the private debt securities market. Prior to 1987 the private debts securities market was virtually non-existent in Malaysia.. The first major move was the issue of M\$100 million worth of the mortgage-backed Cagamas bond in October 1987. Within one year three issues of Cagamas bonds were made with a total value of M\$900 million. Secondary trading of these bonds which is carried out through a network of principal dealers within a selected group of financial institutions has been relatively active. This partly reflects the attractiveness of the bonds in terms of yield, shorter maturity (up to 5 years), the bearer form of certificates, the exemption of transactions from stamp duties and their eligibility as a secondary liquid asset.

Following the success of the Cagamas bonds and the favourable monetary conditions in recent years, several large corporations with good credit standing have

also raised funds through the issue of medium and long-term bonds, promissory notes and convertible bonds. These papers are issued with a defined life and final maturity and pay an agreed return to investors. In general the maturity range varies between two and ten years with coupon rates ranging from 3-8 per cent. Even though the market is still in its early stages of development, rapid growth in funds raised through the above methods has been registered; rising from M\$609 million in 1988 to M\$77 million in 1989 and a big jump to M\$1.7 billion in 1990.

5.3 The Impact of the Recession

What is important to recognize is that the Islamic bank began its operation in a highly competitive financial environment. In addition the bank was confronted with a recessionary climate barely two years after its establishment. It is therefore relevant to outline the impact of the recession on the Malaysian banking system as a background to our assessment of the performance and policy of the Islamic bank during that period.

Whilst the real side of the economy, suffered a stagnation of minus one per cent during the 1985/1986 recession the financial system also faced a series of shocks which brought into focus the overcommitment of many banks and non-bank financial institutions during the period of exuberant growth in the second-half of the 1970s and the early 1980s. The adverse business conditions were also compounded by weak management and in some cases fraudulent business practices that caused heavy losses to some of these financial institutions.

Generally, the recession has led to a 'large overhang of non-performing loans in the banking system'.¹⁷⁵ Between 1975 and 1984 there was a rapid rise in bank

¹⁷⁵ Bank Negara Annual Report 1989:133.

lending which averaged 22.8 per cent. A distinctive feature of bank credit during the period was the significant proportion of loans in property and construction. By the end of 1985, the proportion of total property loan (construction, housing and real estates) accounted for 34.5 per cent of total loans outstanding in the banking system, compared with 26.4 per cent at the end of 1980. In terms of total new loans of the banking system, the percentage extended to the property sector rose to 54.8 per cent at the end of 1986 from 32.2 per cent at the end of 1980.¹⁷⁶

The overconcentration of bank credit in the property sector reflected a number of factors which included the policy undertaken by the Central Bank to encourage home ownership through bank financing since 1977, credit to *bumiputera* contractors and property developers which accounted for the largest amount of credit granted to the *bumiputera* community under the NEP, the demand for commercial property in the manufacturing sector and the demand for high quality commercial and residential property by the expatriate workforce with the influx of foreign investment.

The last factor was of significance because it had pushed up the prices and rental of quality office space and residential property in the major urban centres resulting in a bout of speculation in property. As indicated by a survey conducted by the Central Bank in 1985, the rent and prices of superior quality buildings tripled between 1975 and 1983 bringing about an escalation in the supply of such property in the market. The survey showed that the supply of high-rise commercial property in Kuala Lumpur more than doubled from 12 projects in 1984 to 29 in 1985. A similar trend was also evident in the case of condominium projects where nine were completed in 1985 compared to four the previous year.

¹⁷⁶ Bank Negara Annual Report 1985:157, Sheng 1989:9.

In addition to overlending to the property sector, bank credit was also extended for share speculation in the stock exchange. As corporate profits remained strong over the 1977-1984 period, the Kuala Lumpur Stock Exchange Index rose from 100 in 1977 to a peak of 427 in early 1984 as a result of speculation in corporate securities.¹⁷⁷

It was against this background of domestic over-investment in real estates and wide speculation in equities that the impact of the recession on the real side of the economy began to be transmitted to the financial system.

Firstly, private savings declined by 22.4 per cent in 1985 as a result of lower income following the fall in commodity prices. Private investment, however declined less sharply by 17.9 per cent because of the slow adjustment in private sector expenditure. Growth of deposits with the banking system as a group fell sharply from 20.3 per cent in 1984 to 10.3 in 1985 whilst total loans rose by 14 per cent. As a consequence the loans-deposits ratio of the banking system rose to 94 per cent at the end of 1985. The tight liquidity was reflected by high interest-rates. The mode deposit rates of the 12-month fixed deposits ranged between 9.5 per cent to 10.5 per cent per year in May 1985 while the high demand for loans caused the mode base lending rate to remain at 12.25 per cent per annum since 1984.

The relatively high real rates of interest was an issue of concern because with the economic slowdown, low inflation and declining international interest-rates; downward adjustments were needed to encourage private sector investment as well as relieve the debt-servicing burden of corporations. At the same time, an adequate real rate of interest was also necessary to promote deposits in the face of the widening of the savings-investment gap.

¹⁷⁷ Sheng 1989:9.

Despite measures undertaken by the Central Bank to ease liquidity by reducing the statutory reserve requirement and the minimum liquidity ratio of the commercial banks in mid-1985 the liquidity of commercial banks was still tight. The commercial banks later reduced their base lending rates bringing the mode base lending rate from 12.25 per cent to 10.75 per cent per annum and the 12-month fixed deposit rate to 7.5 per cent per annum.

The first major event which triggered a series of shocks to the Malaysian banking system was the collapse of a large public-listed company in Singapore in December 1985 followed by the sudden suspension of the Kuala Lumpur and Singapore stock exchanges for three days. The direct impact of both events was a run on a finance company associated with a prominent Malaysian businessman with interests in the Singapore quoted company. The arrest of the businessman in January created another spell of withdrawals which was later contained after liquidity was provided by the Central Bank.

Investors' confidence in the Kuala Lumpur Stock Exchange (KLSE) was greatly undermined when the integrity of contracts on the KLSE was increasingly being questioned. This resulted in the decline of share prices and severe diminution in the value of shares. The market capitalisation of all shares quoted on the KLSE declined by M\$11 billion at the end of 1985 followed by another M\$10.1 billion in the first quarter of 1986.¹⁷⁸ At the same time the property market was also on the brink of collapse. By 1986, the price and rental value of prime property in Kuala Lumpur was driven down due to oversupply and forced selling. Many entrepreneurs were caught in a triple squeeze with a sharp decline in income flows,

¹⁷⁸ Bank Negara Annual Report 1985:22.

collapse in asset values and a rise in debt-servicing.¹⁷⁹ As a result of the significant concentration of bank credit in the property sector, the adverse conditions in that sector were transmitted to the banking system in the form of a high incidence of non-performing and bad and doubtful debts for the first time in history at the end of 1985. Hence between 1985 and 1986, the commercial banks in particular were confronted with 'the growing problem of non-performing loans, brought about by the combination of the recession, overgearing by many corporate clients, decline in the security values in land and shares and in some instances, poor credit evaluation and loan documentation.'¹⁸⁰

In response to the non-performing loan crisis, the Central Bank introduced a set of guidelines which required banks to set aside provisions for bad debts and interest-in-suspense beginning from the 1985 financial year.

Table 5.3 — Banking System: Outstanding Interest in Suspense & Bad Debts Provisions 1985-1988 (M\$millions)

Financial Year	Interest-in Suspense	Bad Debts Provisions	Total as % of total loans
1985	1,500	2,493	5.6
1986	2,844	4,056	9.7
1987	4,242	5,188	12.9
1988	5,932	5,722	14.5
Average Annual Growth	59.5%	33.6%	

Source: Sheng 1989 Table 3.

¹⁷⁹ Sheng 1989:10

¹⁸⁰ Bank Negara Malaysia 1989:450.

The high incidence of non-performing loans was reflected by the large provisions made. By 1988 these provisions amounted to M\$11.7 billion or 14.5 per cent of gross loans of the banking system covering approximately 47 per cent of total non-performing loans. The difficulties of the private sector in servicing their debt during the recession were evident in the rapid rise in the interest-in-suspense component. As shown in Table 5.3, interest-in-suspense grew at an average annual rate of 59.5 per cent from M\$1,500 million in 1985 to M\$5,932, while provisions for bad debts rose at a slower rate of 33.6 per cent from M\$2,493 in 1985 to M\$5,722 in 1988.

The impact of these large provisions was severe cuts in bank profits. Many banks reported lower profits while some suffered heavy losses. However, four medium-sized domestic commercial banks¹⁸¹ incurred substantial losses largely because of their involvement in the property sector. It was found that these four banks had expanded their loan base excessively between 1980-1985 depending on collateral with little consideration for project viability and cashflow. According to the Bank Negara Annual Report¹⁸² these four banks had problems of 'overstretched managerial resources, poor procedures and controls and instances of fraud leading to lax control over loans and the high incidence of non-performing loans.' which reflected poor and in some cases dishonest management. To protect depositors' interest and to maintain public confidence in the banking system all four commercial banks were rescued and restructured by the Central Bank by 1989.

Besides the commercial banks, finance companies that lent aggressively to finance real estate development and share acquisition were also hit with losses. By 1984, 11 out of the 47 finance companies reported losses; eight of which were new

¹⁸¹ namely United Asian Bank Berhad, Perwira Habib Bank, Sabah Bank Berhad and Oriental Bank Berhad.

¹⁸² 1989:133.

companies which started between 1979 and the early 1980s. The Central Bank had to assume control over four finance companies which were unable to inject new capital to cover their losses.

In summary the recession in the Malaysian economy was manifested in the financial system by heavy losses in various financial institutions. These losses were characterized by the high incidence of non-performing loans in the banking sector and the inability of the deposit-taking cooperatives to meet deposit withdrawals. Both had emanated from aggressive lending into the property sector and share based lending which cannot be sustained during the unfavourable economic environment. The problem has also been compounded by the lack of prudent and trustworthy management.

5.4 Conclusion

In conclusion, the structure of the Malaysian financial system has developed tremendously from the relatively simple structure of the Currency Board in the 1950s. Starting with the policy of indigenisation and institution-building the Central Bank has undertaken a supply-leading approach to financial development. By the time Islamic banking was introduced in 1983 the Central Bank had brought 38 commercial banks, 41 finance companies and 12 merchant banks under its supervision. The market-oriented approach to interest rate determination, computerisation and the widespread network of branches of the major banks in the early 1980s had also fostered greater competition in retail banking within the banking system. At the same time development banks and specialized institutions designed both to finance development in specific economic sectors and to facilitate the achievement of the NEP targets have also been established. It is apparent that the banking

structure was almost complete with specific institutions to mobilize resources and supply funds in order to promote economic development. Nevertheless, with the exception of *Tabung Haji* there remained a gap in the system for the establishment of an interest-free bank as an alternative to western banking for the Muslim community.

Chapter VI

Bank Islam Malaysia Berhad: Evolution and Framework

6.1 Introduction

Malaysia became the first country in Southeast Asia to join the Islamic Banking movement when Bank Islam Malaysia Berhad (hereinafter referred to as Bank Islam or BIMB) first opened its doors on 1st July 1983. The bank was established to function side by side with the interest-based banks. However, unlike other individual Islamic banks which were established by private initiatives, Bank Islam was established with full support from the Malaysian government not only in terms of legislative provision but also by becoming the major shareholder of the bank. This chapter aims to provide an overview of Bank Islam. It will begin with an outline of the evolution of the bank followed by a discussion on its overall framework, organizational structure and modes of operation.

6.2 Evolution

The establishment of Bank Islam may be attributed to a combination of factors which had acted favourably towards the establishment of a fully-fledged Islamic bank with full approval and assistance from the government. Triggered by the impact of the Islamic resurgence which began in the early 1970s, the demand for Islamic banking amongst Malaysian-Muslims became more pressing towards the end of the decade. In addition, the feasibility of Islamic banking was attested by the impressive success of the Pilgrimage Management and Fund Board (*Tabung*

Haji), the only Islamic financial institution set up to mobilize savings of Muslims intending to perform the pilgrimage. From the political perspective, it is envisaged that the Malay-led government was obliged to support the Islamic cause for the achievement of certain political objectives. On the other hand, the developmental policy of the Central Bank, as shown in Chapter V, can also be viewed as a contributory factor that had motivated the government to hold a major share in the bank.

6.2.1 The Malaysian-Muslims

Since Muslims in Malaysia are predominantly Malay in terms of their racial identity, the study of Islamic banking in Malaysia will inevitably develop against the background of this ethnic community. At the outset there is a deep-rooted relationship that bonds Islam and the Malay identity. Islam has always been the religion of the Malays since the official conversion of the first Malay ruler of the Malacca Sultanate in the fifteenth century. Over the centuries, the original animistic beliefs of the Islamized Malays have been gradually substituted by ideas and institutions inspired from the *Quran* and other sources of Islamic law. The internalization of Islam has been so profound that Islamic belief, sentiments and values now serve as the foundation of the Malay culture and value system that Malay identity is almost interchangeable with Muslim identity.

Because of this strong bondage, all Malays in Malaysia are born Muslims and by constitution the proselytization of Malays by other faiths has not been permitted. Islam is the declared official religion even though this did not suggest that Malaysia is an Islamic State. In the context of the Malaysian plural society Muslims are therefore identifiable with the Malays or *bumiputera*; as a result Muslim

interest is almost inseparable from the Malay or *bumiputera* interest, politically.

The 1980 population census showed that there were 6.9 million Malaysian Muslims in 1980; representing 53 per cent of the total population of 13.07 million. A majority of these Muslims (88.4%) were located in the Peninsula in 1980. Some 75.4 per cent of them were concentrated in the rural areas and comprised 60.5 per cent of the rural population in 1980.

As reflected by the socio-economic position of the Malays, Muslims in Malaysia traditionally live in the rural areas depending on agriculture as their livelihood and they constitute the majority of the poor in the country. Before independence in 1957 and in the 1960s, the Malay-Muslims were economically identified as subsistence farmers and fishermen in the rural areas. In 1990, although most Malays continue to live in the rural areas, an increasing number of them have migrated to the urban areas. A majority of urban Malays are employed in the public sector. Those working in the private sector are mostly employed in the unskilled and lower paid jobs and a sprinkling 30 per cent work as professionals such as accountants, engineers and architects with high income.

Given the Muslim underdevelopment the establishment of Islamic banking in the 1980s would not have been possible without legislative and financial support of the government. Unlike the Chinese businessmen who set up the first domestic banks in the 1930s, Muslims in general did not have the resources to establish their own bank. Malay entrepreneurs in the 1980s were still dependent on state assistance to survive in the business and commercial sector and establishing a bank was likely to be beyond their financial means generally.

6.2.2 The Impact of Islamic Resurgence

“The decade of the 1970s in Malaysia coincided with the rise of the *da'wa* (Islamic proselytization) phenomenon marked by the mushrooming of private Muslim organizations for the purpose of spreading the message of Islam to Muslims and non-Muslims alike ” (Hassan, 1987:182). This phenomenon was largely prompted by events surrounding the worldwide resurgence of Islam at the international level. The success of the Iranian Revolution in 1979 followed by the establishment of the Islamic Republic of Iran exerted a tremendous impact upon Muslims around the world. Muslims began to perceive that an Islamic movement can gain political power and preserve that power in the form of an Islamic State even in modern times. More importantly, the implementation of Islamic laws by the Iranian government to Islamicize the economy, the education system and the cultural life of the people showed that an Islamic state does have its own identity. This provided a great inspiration to young Muslims in other countries, including Malaysia, to emulate the changes in Iran in the attempt to exert an exclusive Islamic identity amongst themselves.

The internal factors that have motivated the increasing awareness towards Islam amongst the Malays are more complex to explain. Nevertheless, studies on Islamic resurgence in Malaysia¹⁸³ have observed close associations between the massive turn towards Islam amongst urban Muslims and the ethnic situation. It was perceived that large scale movements of Malays to the urban areas and of Malay students into the universities at home and abroad under the NEP, had created an increasing awareness among the Malays of their ethnic identity. It was argued that because the urban atmosphere was ethnically alien compared to the villages

¹⁸³ see Funston 1981, Mehden 1980, Muzaffar 1986.

(where everyone were of the same race and shared the same religion, culture and language) the newly-arrived Malay migrants had become acutely conscious of their own ethnic identity and had turned to Islam as a medium to assert this identity since all Malays tend to be Muslims and that a vast majority of non-Malays are not Muslims.

At the society level, the renewed commitment to the Islamic faith was manifested by the greater conformity to the Islamic way of life. This was evident in the case of daily prayers, attire, food, lifestyles and even in the conduct of business. Various Islamic organizations and societies committed to the pursuit of Islamic ideals have also mushroomed, generating renewed scholarly interest in Islam amongst the Muslim intellectuals and their young followers. The most influential Muslim youth organization ABIM was advocating the idea of Islam as a comprehensive system which touches all aspects of human life. This new understanding of Islam was echoed in countless seminars and forums consequently leading to calls for the establishment of an Islamic economy, an Islamic education system, an Islamic legal framework and most of all an Islamic state.

The idea of setting up an Islamic bank in Malaysia was one of the resolutions which emanated in these public discourses and debates. The establishment of an Islamic alternative to western banking was seen as the first important steps towards the elimination of *riba* in the economy which would eventually lead to the establishment of an Islamic economy. The demand for Islamic banking in Malaysia became more pressing as more Islamic banks were being established abroad. Continuous pressure was also made on the government to assist in the formation of such a bank.

The first formal resolution was passed by the 'Bumiputra Economic Congress' in 1980 calling upon the government to allow *Tabung Haji* to establish a full-fledged Islamic bank in Malaysia. A year later, another resolution was adopted by the 'National Seminar on the Concept of Development in Islam' requesting the government to take immediate actions in legislating an Act that would facilitate the establishment of banks and financial institutions on Islamic principles in Malaysia.

Besides these public demands, independent and private efforts were also undertaken jointly by some Malay/Muslim-based organizations such as the *Tabung Haji*, the Muslim Welfare Organization of Malaysia (PERKIM), the Development Bank of Malaysia, Bank Bumiputra Malaysia Berhad and Malay leaders from other financial institutions to expedite the formation of the Islamic bank. The first practical step undertaken was the establishment of a committee called 'The Study Group on Islamic Banking Committee'. The objective of this committee was to study various aspects of Islamic banking and its implementation in Malaysia. Its efforts culminated in a study tour of some Islamic banking institutions in the Middle East, including the International Association of Islamic Banks and the Faisal Islamic Bank in Cairo; and the Faisal Islamic Bank Sudan; after which a memorandum was made to the government containing two main proposals. Firstly, it was proposed that the establishment of an Islamic bank should be coordinated at the national level and secondly that a National Steering Committee on Islamic Banking should be appointed by the Prime Minister. These proposals were accepted by the government and in response the National Steering Committee on Islamic Banks was appointed on July 1981. The seriousness with which the issue of the establishment of the bank was pursued was also evident at the Cairo Seminar on Islamic Banking and Economics held in August to September 1981 where the

Malaysian delegates constituted the largest group sent by any individual country.

6.2.3 The Response of the Government

The writers on Islamic resurgence in Malaysia¹⁸⁴ also indicate that the UMNO-led government in the 1970s viewed the *da'wah* phenomenon with some degree of apprehension for a number of reasons and found it necessary to deal with this new wave of Islamic fundamentalism.

It was argued that the growing popularity of ABIM and its central message of the importance of Islam as a *deen*; a self-sufficient way of life that holds the key to all man's problems¹⁸⁵ worried the power-holders in UMNO who saw a new threat to its approach of political compromise between the major ethnic groups. Even though ABIM had never outwardly called for the creation of an Islamic state¹⁸⁶ it had made justifiable criticisms of some government policies which were considered oppressive and unjust in several respects.

The views of ABIM had also struck a responsive chord amongst a large section of the Muslim population. Many of ABIM supporters were young, educated Muslims within the Malay middle class. According to Muzaffar¹⁸⁷ this middle-class tendency had 'generated tremendous fear among the UMNO leaders because until the resurgence, the Malay middle-class was solidly behind the party'. Moreover, Islamic resurgence was more in line with the principles of the Islamic opposition party, PAS which was fast gaining support from the Muslim masses. Its public support for the Islamic state, its criticisms on the failure of the NEP to eradi-

¹⁸⁴ see Funston 1981, Muzaffar 1986, Hassan 1987

¹⁸⁵ Funston 1981:174.

¹⁸⁶ Anwar 1987:24.

¹⁸⁷ 1986:80.

cate poverty and its open intentions to change the existing economic system were important issues which UMNO could not afford to ignore.

In response to these imminent threats UMNO began efforts to project an Islamic image by responding to the Islamic resurgence. At the same time, the success of PAS in winning many seats in the 1969 elections led to its inclusion in the UMNO-led coalition government from 1973 to 1978. This saw the creation of numerous Islamic Affairs divisions and committees in the government and a series of Islamic programmes over the media. The main aim was to emphasize how much the UMNO-led government had done for Islam and the importance of supporting the government's moderate approach to Islam in order to avoid the dangers of religious extremism in a multi-religious society.¹⁸⁸

The response of the UMNO-led government to appease its voters within the Malay middle class became more pronounced with the introduction of its Islamization programme in 1982. This programme which was aimed at the Malay middle class includes the 'inculcation' or the 'infusion' of certain 'Islamic values' in government administration, the dissemination of Islamic values in schools and universities, the implementation of new Islamic laws on Muslims and the establishment of Islamic institutions.

The establishment of Bank Islam by the government therefore came under this series of Islamic reforms. It was claimed to be a manifestation of UMNO's commitment to undertake a gradual Islamization process of the Malaysian social and economic institutions. Sceptics however saw it purely as a political strategy to gain Malay political support for the general elections. It was envisaged that since PAS had moved out of the coalition in 1978, the establishment of an Islamic bank

¹⁸⁸ Muzaffar 1986:6.

was meant to 'take the thunder away from PAS.'¹⁸⁹ in the 1982 general elections. As asserted by Muzaffar (1986); given the capitalistic structure of the economy, the benefits of the Islamic bank in terms of financing and profits would flow mostly to the Malay middle-class and UMNO could hope to win their support on this account. In the context of gaining support from the rural Malay voters, the Islamic banking project would provide an Islamic image to UMNO and would benefit the party in diluting the support of the rural Malays towards PAS, UMNO's chief rival in the rural areas.

6.2.4 The Success of Tabung Haji

The readiness of the government to accept the proposals of the Study Group towards the formation of the National Steering Committee on Bank Islam may also be attributed to the fact that the Study Group was spearheaded by *Tabung Haji* the Pilgrimage Management and Fund Board, which had showed a profitable track record in mobilizing deposits from Muslims. When the Islamic banking proposal was submitted by the Steering Committee in 1981, *Tabung Haji* had proved to be a successful interest-free financial institution. By the end of 1981, the total resources of *Tabung Haji* had reached almost M\$300 million. About 51,000 Muslims had become its depositors since 1969 with total deposits amounting to M\$108 million. It had 40 branches all over the country, three fully-owned subsidiaries and had interests in 25 private and 50 public companies. Its profits before zakat was M\$32.4 million from which it was able to pay dividend at a competitive rate of 9 per cent per annum to its depositors.

Obviously, it was the achievements of *Tabung Haji* which provided the plat-

¹⁸⁹ Ariff 1988:200.

form for the viability and credibility of Islamic banking in Malaysia. The impressive figures of Tabung Haji's success served to indicate that a potential market had already existed for Islamic banking services in Malaysia. In this respect it was conceived that the establishment of Islamic banking in Malaysia was not without historical antecedents.¹⁹⁰ Even though generally speaking the demand for Islamic banking in Malaysia is closely related to Islamic resurgence, a closer study of the establishment of *Tabung Haji* would reveal that the idea of an Islamic financial institution for the Muslims in Malaysia has been conceived in 1959 ten years before contemporary Islamic awareness even began in Malaysia.

It may be worth noting that the establishment of *Tabung Haji* was proposed primarily on economic grounds by an economics lecturer, Ungku Abdul Aziz from the University of Malaya as a result of his research¹⁹¹ on the Malay-Muslim population living in the rural economy in the 1950s.

The study by Ungku Aziz revealed two important facts about the saving behaviour of the Muslims. Firstly, their biggest single motive for savings was for the purpose of the *hajj* or the pilgrimage to Makkah. Secondly, such savings were made through uninstitutionalized and traditional methods of savings mainly to avoid *riba* in the interest-based banks.¹⁹² Ungku Aziz was concerned by the substantial amount of money being hoarded and laying idle outside the financial framework as well as the economic plight of some pilgrims who returned to nothing after having sold all their possessions to perform the *hajj*. To provide a remedy to the situation, Ungku Aziz presented a memorandum to the government in 1959 entitled "A Plan to improve the Economic Position of Future Pilgrims." In this

¹⁹⁰ Ariff 1989:2

¹⁹¹ Aziz U.A 1951, 1959.

¹⁹² Abdul Kader 1991:150.

paper Ungku Aziz suggested that since the savings facilities in the interest-based banks were unacceptable a solution that could mobilize the savings of the Muslim population for productive use would be to establish a financial institution which would involve profits instead of interest.

The need for an interest-free financial institution was further emphasized in another study by Chou¹⁹³ which revealed that less than five per cent of the Muslim majority states of Kedah, Perlis, Kelantan and Trengganu had any form of deposit account with the banking system.

As a consequence of these findings and the endorsement of Ungku Aziz's Plan from the point of *Shariah* by Sheikh Mahmud Shaltout, the Rector of Al-Azhar University Egypt the Pilgrims Savings Corporation was set up through an Act of Parliament in 1962. The Corporation began its operations in November 1963 to receive savings from Muslims and then to utilize these funds in *Shariah* permitted investments for profits. Six years later the Corporation was expanded under a new name, "*Tabung Haji*" or the Pilgrims Management and Fund Board to serve not only as an interest-free savings institution for intending pilgrims but also as a service organization that would manage the affairs of Malaysian pilgrims.

As a non-bank financial institution the role of Tabung Haji has been rather limited and its operations lay outside the boundaries of commercial banking. This implied that the establishment of Islamic commercial banks would not impede the growth of Tabung Haji nor cause a major drain in its deposits. As an institution which serves special functions for pilgrimage it was envisaged that the savings facilities at Tabung Haji would continue to attract long-term savings for the purpose of pilgrimage. Nonetheless, the needs of the Muslim population for

¹⁹³ Command Paper No 22,1962:7.

interest-free transactionary deposit facilities and Islamic modes of financing could only be fulfilled by a full-fledged Islamic bank.

In summary it was the success of *Tabung Haji*, the public demand for Islamic banking and most importantly the favourable political climate that had prompted the government to fully support the establishment of an Islamic bank in Malaysia. UMNO had the political will to embark on such a project, the constitutional power to legislate it and the resources (with the large increase in oil revenue in 1980) to provide financial support in terms of share ownership.

As expected, the support given by UMNO to the Islamic banking project did not go uncriticized. Sceptics saw that the Islamic banking scheme had been “designed to introduce non-*riba* alternatives as a marginal operation so that the demands for total change in the economic system [could] be thwarted”¹⁹⁴ To both ABIM and PAS the scheme, in fact the whole concept of Islamization pursued by the government, did not reflect a genuine commitment to Islam as a complete way of life. Since the Islamic bank should exist in an interest-based financial system, ABIM saw it “as a form of patchwork within a system alien to Islam”¹⁹⁵. Similarly, PAS rejected the scheme which it viewed “as ‘cosmetic Islamization’, as a sort of label stuck onto a system that had nothing to do with Islam”¹⁹⁶. According to PAS, Bank Islam was not an Islamic bank, but was merely a ‘Halal bank’ in view of its interest-free characteristic.¹⁹⁷

In conclusion, whatever the real intentions of the government were in supporting the Islamic banking scheme it cannot be denied that the political climate has

¹⁹⁴ Islamic Finance, July 1982:56.

¹⁹⁵ Muzaffar 1986: 82.

¹⁹⁶ Muzaffar *ibid*.

¹⁹⁷ Hjarpe 1986:342.

played a major role in leading to the birth of Bank Islam.

6.3 The Framework of Bank Islam

When the National Steering Committee on Islamic Banking (henceforth referred to as the Steering Committee) submitted its report on 5 July 1981 it outlined the framework of Bank Islam into three major aspects namely (a) the legal and regulatory framework (b) the organizational framework and (c) the operational framework. Since all the recommendations of the Committee were accepted by the government, our discussion will also follow along these lines and will draw heavily on the proposals and the recommendations of the Committee.

6.4 The Legal and Regulatory Framework

The essential prerequisite for the establishment of an Islamic bank in Malaysia was a legal framework which would enable the bank to operate on the principles of the *Shariah*. The existing Banking Act 1973 did not fit the needs of Islamic banking because it required all banks in Malaysia to operate exclusively through interest and at the same time prohibited all forms of trading in the banking operations (Banking Act 1973, Section 31). A new Act which conformed to the principles of Islamic banking was therefore necessary. Upon the recommendation of the Committee, an Act modeled on the Banking Act 1973, was legislated and passed in 1983 known as the Islamic Banking Act 1983.

6.4.1 The Islamic Banking Act 1983

The details of the Act are shown in Appendix A. Basically, the Act draws special provisions which would enable the formation of Islamic banks in Malaysia and allow these banks to operate on the principles of *Shariah*. The normal practices

of prudent banking contained in the Banking Act 1973 are still retained. As in the case with other commercial banks in Malaysia the Islamic banks would also be subjected to the supervision and the regulations by the Central Bank. The essential differences are the additional Islamic supervision by a Religious Supervisory Council and specific liquidity requirements which apply only to the Islamic banks. As shown in Appendix A the Act is divided into sixty sections which are grouped into eight parts which can be summarized as follows:-¹⁹⁸

Part I gives the title of the Act, its commencement and application throughout Malaysia. The interpretation of terms pertaining to the operations of the Islamic banks are also defined here.

Part II underlines the requirements of the licensing of Islamic banks in Malaysia. There are two important provisions here;

- (i) The Islamic bank should be incorporated as a licensed public limited company under the Companies Act 1965.
- (ii) The operations of the Islamic bank must be supervised by a Religious Supervisory Council to ensure compliance with the *Shariah*.

Part III underlines the financial requirements and duties of the Islamic bank. The Bank is required to maintain as reserves certain percentages of its capital funds, reserve funds and liquid assets as determined or approved by the Central Bank. It is also obliged to provide the Central Bank with information, bank statements and statistics about its annual financial situation and banking operations.

¹⁹⁸ Ismail 1983:57.

Part IV deals with the ownership, control and management of Islamic banks.

Part V relates to the restrictions which the Bank is obliged to observe in its business.

Part VI outlines the powers of supervision and control vested to the Central Bank over the Islamic banks such as to investigate and examine the books of the banks, documents or the accounts of any individual customer under the conditions of secrecy.

Part VII provides for miscellaneous matters such as indemnity, the priority of savings account liability, the penalties on directors and managers; the prohibition of the receipt of commission by the Bank's staff and the application of the other laws in the Companies Act 1965 which do not contradict the provisions in the Islamic Banking Act 1983.

Part VIII contains provisions for certain consequential amendments that need to be made to the Companies Act 1965, the Banking Act 1973, the Finance Companies Act 1969 and the Central Bank of Malaysia Ordinance 1958 in order to enable the Islamic Bank to carry on its operations

In relation to provision (i) in Part II above, which requires the establishment of the Islamic bank as a public limited company it may be worth noting that within the Malaysian legal environment, a bank can also be established as a statutory body. However, it was felt that the establishment of an Islamic bank as a private business concern would be more viable. This was because the bank would be in a better position to conduct its business if it was given the same autonomy as the other interest-based banks, without being constrained by the regulations that were normally imposed on statutory bodies. It was also argued that although

some of the corporate objectives of the bank pertained to the social and spiritual well-beings of society the bank should be a business concern which, in the final analysis, had to depend on factors such as business viability and performance for its survival. Based on the opinion that profits were acceptable in Islam and that in Islam the concepts of viability and profitability as a basis for all business dealings did not contradict the *Shariah* the establishment of the bank as a public limited company would be more in line with the concept and the philosophy of an Islamic bank.

Besides being an interest-free bank, the supervision of the Islamic bank by an additional body called the Religious or *Shariah* Supervisory Council further differentiates the Islamic bank from its interest-based counterparts. The importance of the religious advisory committee is to supervise the operations of the Islamic bank in respect of their compliance with the *Shariah*. As emphasized in Part II 5(b) of the Islamic Banking Act;

“The Central Bank shall not recommend the grant of a license, and the Minister shall not grant a license unless... there is in the articles of association of the bank concerned, provision for the establishment of a *Shariah* advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam ”

The Steering Committee recommended that the presence of a Religious Supervisory Council was vital because the Bank, in the course of its operation, was likely to meet with problems in determining the legality of certain proposed activities from the standpoint of *Shariah*. To instil public confidence in the Islamic legality of the Bank operations, it was also felt that members of the Religious Supervisory

Council should comprise Muslim religious scholars in the country and that membership should be a minimum of three and a maximum of seven. Decisions by the council should be based on Islamic consensus (*ijma'*) and not on the basis of majority; and that the Bank auditors were required to ensure that those decisions were adhered to by the Bank.

The provisions in Part III requires Bank Islam to fulfil certain statutory reserve and liquidity requirements set by the Central Bank. There are two minimum liquidity ratio requirements which Bank Islam has to comply.

(i) the primary liquidity ratio of 10 per cent which is expressed as a ratio of total liquid assets to total deposits excluding the investment account liabilities.

(ii) the secondary liquidity ratio of 5 per cent which is expressed as a ratio of liquid assets to investment account liabilities.

The minimum liquidity requirement for the second ratio is relatively lower because the liability of investment deposits are not fully guaranteed by the Bank under *mudarabah*.

With the enactment of the Islamic Banking Act 1983 it is apparent that the Malaysian government has no intention of Islamizing the entire financial system as in Iran and Pakistan. By making the necessary amendments to the Banking Act of 1973 Islamic banking has been given a status equal to that of the interest-based system. Both systems are expected to operate parallel to each other under the supervision of the Central Bank. The survival of the interest-based system was assured by the Prime Minister Dr. Mahathir Mohammad "who once remarked that the new bank was not going to hurt anybody but it would definitely please those

who did not use the services of interest-based banks on the grounds of religion”¹⁹⁹.

6.4.2 The Government Investment Act 1983

As shown in Chapter V the early 1980s coincided with the period of financial deepening in the development of the Malaysian financial system. New financial instruments such as the BAs and NCDs have been introduced to facilitate transactions in the money market. Hence when the Islamic banking proposal was made the Steering Committee also took into account the need to create an Islamic financial instrument for the secondary market. This led to the enactment of the the Government Investment Act 1983²⁰⁰ which authorizes the Central Bank to issue profit-bearing government bonds which give returns in the form of dividends rather than interest. These bonds are called the Malaysian Government Investment Certificates (MGIC) with maturity periods of one year or more and can be bought in the multiples of M\$10,000. Since these certificates are money market instruments, their transactions are not restricted to the Islamic bank but are open for purchase by other financial institutions in the market.

Another distinct characteristic of the MGIC is that even though it is called an investment certificate, in principle it operates on the basis of *Qard al Hasan* or benevolent loan. This is because the repayment of the principal is guaranteed upon maturity and the payments of dividends are not based on the principle of profit and loss sharing. Instead the rates of dividend are determined according to the absolute discretion of the Ministry of Finance, and hence the dividends paid can be regarded as *hiba*, a gift or an incentive in return for the benevolent loan.

¹⁹⁹ Huq 1986:10.

²⁰⁰ Details of the Act is shown in Appendix B.

In summary, the legislation of the above two Acts has enable the Central Bank to initiate and supervise the development of Islamic banking in Malaysia. The first Act provided the necessary amendments to the existing banking regulations to allow Islamic banks to operate without interest and also to engage in trade and commerce which was initially prohibited in the banking system. The second Act, on the other hand, has helped the Islamic bank to meet its liquidity requirement in terms of its liquid asset holdings. As these certificates are regarded as liquid assets and are transferable they serve as a means for the Islamic bank to comply with the liquidity requirements prescribed by the Central Bank. At the same time this Act provides a solution to the problem of interest-free short-term investments by the Islamic bank for its surplus funds, a problem which is common to all Islamic banks in the absence of the Islamic money market today.

6.5 The Organizational Framework

According to the Steering Committee on Islamic Banking the organizational structure of the Islamic bank must essentially reflect its corporate objectives and primary functions. At the same time flexibility should also be given to the management of the bank in making suitable changes to the existing structure at any one time, depending on the stage of development and emerging needs.

At the outset, the primary objective of Bank Islam is

to conduct all business of the company...in accordance with Islamic principles, rules and practices.²⁰¹.

Following this, its corporate objective is

²⁰¹ Ismail 1983:55.

to operate as a commercial bank functioning on the basis of Islamic principles, providing banking facilities and services to Muslims and the whole population of this country, with viability and capability to sustain itself and grow in the process.²⁰²

6.5.1 Organizational Structure

In order to achieve the above objectives, the organizational structure of Bank Islam has been set up as shown in Appendix C. This structure reflects the initial conceptualization of the possible activities of the bank and has been viewed by the bank management as a dynamic set-up capable of being modified and improved in the light of actual experience.²⁰³

With reference to Appendix C. the organizational structure of Bank Islam can be divided into two separate sections according to function. On the one end are three Divisions which perform the line functions of (a) Retail Banking, (b) Trade Finance and Treasury and (c) Corporate Banking. At the other end are three other Divisions with staff functions of (a) Human Resources, (b) Accounts and (c) Legal and Secretarial. Each division is in turn divided into departments which are further divided into units as deemed necessary.

A significant feature of the structure pertaining to the line functions is that the trade finance functions were deliberately separated from the ordinary retail banking business. The main purpose is to strengthen the capability of the Bank in providing trade finance services which are usually short-term in nature as part of its effort in finding short-term investments for its surplus funds.

At the apex of the organization are the Board of Directors comprising the

²⁰² Ismail op.cit:58.

²⁰³ Ismail ibid.

nominees of the bank's major shareholders who are elected at the Annual General Meetings. The Managing Director and the Internal Auditor report directly to the Board while the *Shariah* Supervisory Council advises the Board on all areas of operation related to the Islamic rulings.

The management of the bank is spearheaded by a Management Committee consisting of the Managing Director and the Senior General Manager and the general managers of the Divisions.

6.5.2 Branch Network

In relation to its corporate objective of providing Islamic banking services across the country Bank Islam needs a network of branches in all areas particularly where the population is predominantly Muslim and where the need for Islamic banking is apparent. The Steering Committee recommended that Bank Islam would be in a better position to reach its potential customers through its branch network if it is given a monopolistic position during the first ten years of its operations²⁰⁴. This means no license would be issued for the establishment of other Islamic banks until 1993. With this ten-year monopoly status, the bank management has drawn up plans to open three to four new branches per year subject to the approval of the authorities until it reaches its tenth year of operations in 1993. During its first year of operation (July 1983-June 1984) Bank Islam was given the permission to open four branches. By June 1991 its network of 29 branches has reached the capital towns in all the states and the bank is now concentrating on establishing its branches in the smaller towns.

²⁰⁴ Steering Committee Report: 40-41.

6.5.3 Subsidiary Companies

Bank Islam has formed the following three subsidiary companies with special functions namely to facilitate in its financing and investment activities.

1. The Al-Wakalah Nominees Sendirian Berhad which is owned wholly by Bank Islam. Its function is to provide portfolio management and nominee services for the bank and its customers.
2. The in-house leasing company, Syarikat Al-Ijarah Sendirian Berhad which is also owned wholly by the bank. Its principal activity is to acquire and lease fixed assets to the bank.
3. The Syarikat Takaful Malaysia Sendirian Berhad, an 87 per cent owned subsidiary which is mainly engaged in the *takaful* or Islamic insurance business.

The paid-up capital for these subsidiaries is obtained from the shareholders' funds of the bank.

6.6 Operational Framework

As a commercial bank the basic function of Bank Islam is that of a financial intermediary which accepts deposits from the public and invests them for the purpose of profits. Generally the operational framework of Bank Islam is similar with other Islamic banks in terms of the mobilization and utilization of deposits. Its funds are derived from its shareholders as well as from its depositors.

6.6.1 Sources of Funds

Almost the whole of the bank's funds are obtained internally from its shareholders and depositors. These two types of funds are managed separately by the

Treasury Department of the bank.

6.6.1.1 Shareholders' Funds

The main component of the shareholders' funds on the credit side of the bank's balance sheet is its paid up capital contributed by its shareholders.

When Bank Islam was incorporated its authorized capital was declared at M\$500 million divided into 500 million ordinary shares of M\$1 each. Its initial paid-up capital was recommended at M\$100 million by the Steering Committee; which would place Bank Islam among the top five domestic banks in Malaysia in terms of capital and reserves based on the 1981 figures. The recommendations for a sizable paid-up capital was based on two premises.

First, a sizable capital would reflect the strength and the stability of the Bank; two important factors that would attract deposits either for investment or transactionary purposes. Second, the absence of interest on the current and savings accounts in Islamic banking would mean that the cost of funds in these accounts must be adequately covered by capital and reserves. On this argument, the larger the amount of the bank's capital, the larger the deposits it can accept in the form of these accounts.

The recommendations of the Steering Committee were not fully accepted because when Bank Islam started its operations its initial paid-up capital was M\$80 million which was M\$20 million less than the amount recommended by the Steering Committee.

With regards to its shareholders it was recommended by the Committee that it would be wise if the participation in the paid-up capital of the bank in the initial

stage was not offered to the public in view of the uncertainties and challenge that the bank was likely to face in its pioneer stage of developments. Instead it was suggested that the initial shareholders should include only the Government of Malaysia which would hold the largest amount of shares, Tabung Haji, other Islamic statutory bodies and qualified enterprises in the public and private sectors. The purpose of granting the biggest proportion of shares to the government was to promote public confidence in the bank and also because of the large amount of initial paid-up capital proposed of, which only the government was in a position to buy a large share. It was planned, nevertheless, to list the bank on the stock exchange at a later stage, when it had developed into a successful and profitable institution.²⁰⁵ Hence when Bank Islam was incorporated on 1st July 1983 its list of shareholders were as follows:

Table 6.1 — Shareholders of Bank Islam as at 31 December 1989

Shareholders	M\$ million	% share
Ministry of Finance	30	37.5
Tabung Haji	10	12.5
PERKIM	5	6.25
State Religious Council	20	25.0
State Religious Agencies	3	3.75
Federal Agencies	12	15.0
Total	80	100

Between March 1990 and January 1992 several capital restructuring exercises

²⁰⁵ Steering Committee Report *ibid*:21.

were undertaken by Bank Islam to increase its paid-up capital in order to accommodate for the growth of its assets and also to prepare for future expansion.

In March 1990, the federal government stake of M\$30 million was reduced to M\$16 million (20%) when an investment company JAMI (joint Arab-Malaysian Investment)²⁰⁶ bought 17.5% (M\$14 million) of the government stake.

The first injection of fresh capital began in April 1990 with the issue of 197,000 new ordinary shares at M\$1.05 each to eligible employees of Bank Islam under the Employees' Share Option Scheme (ESOS). Following the issue the paid-up capital increased to M\$80.07 million.

Further new share issues and capital restructuring were made in 1991 to pave the way for the public listing of Bank Islam on the Kuala Lumpur Stock Exchange (KLSE). These include:

1. the new issue of 116,500 shares of M\$1.00 each at par under ESOS.
2. the issue of one special share of M\$1.00 to the Minister of Finance on behalf of the Malaysian government.
3. the issue of 3.6 million shares at M\$1.00 each to acquire 36.15 per cent equity from minority shareholders in the Islamic insurance subsidiary company. On the basis that one new Bank Islam share was to be issued for every one share of the subsidiary company held, Bank Islam ownership over the subsidiary was increased from 51 per cent in 1983 to 87.15 per cent.

²⁰⁶ A consortium owned by the SAAR Corporation, Dallah Al-Baraka Group and Al-Rajhi Banking and Investment Corporation.

4. a rights issue involving 27.8 million of new shares at M\$1.50 per share.
5. a public issue of 18.2 million new shares of M\$1.00 each at M\$2.00 per share; of which 1.6 million have been allocated to eligible employees and directors of Bank Islam and the remaining 16.7 million to the Malaysian public. In conjunction with the public issue the paid-up capital of Bank Islam was listed on the KLSE on 17 January 1992.

Hence as a result of these new share issues the paid up capital of Bank Islam was increased to M\$133.4 million with a new capital structure as shown in Table 6.2.

Table 6.2 — Bank Islam: Capital Structure as at 30 January 1992

	No. of Shares
Initial share capital	79,900,000
ESOS(extension)	2,654,500
Special Issue(Minister of Finance)	1
Acquisition of Insurance Subsidiary	3,615,000
Rights Issue	27,894,500
ESOS(new shares)	116,500
Public Issue	18,228,000
Total Share Capital	133,408,501

Source: Bank Islam Malaysia Berhad

With the capital restructuring scheme the Malaysian government share ownership has been further reduced to 15.9 per cent. Nevertheless it still remains the major shareholder, followed by JAMI Company (13.8%) and *Tabung Haji* (10.4%). On the whole 51 per cent of Bank Islam ownership belong to *bumiputera* inter-

ests, as required by the KLSE. The remaining 49 per cent are held by minority shareholders including 13 per cent from the Middle-East.

Specifically, the additional equity was needed by Bank Islam for three main reasons; namely

(a) to improve its capital adequacy ratio in order to comply with the Central Bank's capital adequacy requirement of 8% minimum. As at 31 June 1991 the capital adequacy ratio of Bank Islam was slightly below 10%. However, the ratio doubled to 20% after the flotation exercise.

(b) to increase the nominal credit limit to a single customer which the Central Bank has set at 30% of the shareholders' fund of commercial banks (including Bank Islam. A bigger shareholders' fund would give the bank a higher credit limit to a single customer and a greater competitive advantage in the market.

(c) to inject capital into existing and new subsidiaries.

Bank Islam also benefits from the public listing in terms of creating a ready market for the shares held by its existing shareholders who would be able to buy and sell the shares in accordance to their preferences. It also allows Bank Islam to raise additional funds directly from the capital market and have greater flexibility in its investment in future. The public is also now able to participate directly in the equity of the bank and a share in its profits.

6.6.1.2 Customers' Deposits

Deposits form the largest source of funds for Bank Islam. At the end of June 1990 deposits from customers accounted for 85.6 per cent of the total liabilities of Bank Islam as a group. The bank accepts deposits from its customers through

three types of accounts, namely:-

1. Current Accounts
2. Savings Accounts
3. General Investment Accounts

In addition, deposits are also received under the Special Investment Accounts from selected clients in the corporate and government sectors.

1. Current Accounts

These accounts are operated in the same way as the current accounts in the conventional banks. Deposits are received on the principle of *al-wadiah yadhamanah* or safe-keeping with guarantee. Under this arrangement Bank Islam accepts deposits and guarantees their safe custody and refund on demand. Cheque books are given to the depositors for the purpose of withdrawals which can be made at any amount up to the total of credit balances available in the individual's account.

Current accounts are opened, from the point of view of the depositors, to serve as means of transaction, payment and liquidity. Hence no returns or profits are expected from the bank. Moreover, permission is granted by the depositors for Bank Islam to utilize these deposits as its own resources and that all profits generated would belong to the bank.

In practice however, Bank Islam pays 25 per cent of profits generated from the use of current account deposits which belongs to its government and institutional depositors. This is to remain competitive with other commercial banks which pay interest on the large credit balances of their institutional depositors.

Any individual or entity wishing to open a current account in Bank Islam has to abide by certain requirements set by the Rules of the Association of Banks in Malaysia. Firstly, the applicant is normally required to be introduced by an acceptable third party who is preferably a customer of the bank. The necessity for an acceptable introducer is a legal requirement which is followed by all commercial banks in Malaysia as a matter of prudence. Cases of dishonest use of cheques in the past have shown that a bank is considered negligent by the court and has to suffer losses and damages if the account holder involved has not been properly introduced.²⁰⁷ The introducer, however, does not bear any financial liabilities on behalf of the account holder. A further requirement for opening a current account is a minimum deposit of M\$500 and if the average daily balance is less than M\$1000 for a period of six months, which is considered not profitable to the bank, a service charge of 10 ringgit can be imposed on the depositor and will be debited from his account.

2. Savings Accounts

As implied by its name the savings account is a deposit account. It serves as a means for depositors to place their savings in safe-custody at Bank Islam and earn returns on their deposits at the same time. Deposits for savings accounts are accepted by Bank Islam on the principle of *al-wadiah yadhamanah*. As with the current accounts, these deposits are guaranteed and may be withdrawn on demand. The Bank is also given permission by the depositors to utilize their deposits. In principle all profits generated will belong to Bank Islam. Even though the bank is not liable to distribute these profits it does give some returns to the savings account depositors from time to time as a form of gift or bonus. The rate at which

²⁰⁷ Phang 1991:95.

these returns are given is determined by Bank Islam at its absolute discretion. At present Bank Islam pays 50 per cent of the profits generated from the use of the savings account deposits to its depositors. Profits are payable half yearly and are calculated on a minimum monthly balance basis.

A savings account can be opened with a minimum deposit of M\$1 and an introduction is generally not required. Depositors are provided with the Savings Pass Book in which their credit balances are recorded and this book must be handed to the Bank when making withdrawals. Other usual services connected with the savings account are also provided to the depositors.

3. General Investment Accounts

These accounts are provided for investors who are willing to invest their funds on the principle of *mudarabah* for various periods of time as specified below:

1 month	12 months	36 months
3 months	15 months	48 months
6 months	18 months	60 months and over
9 months	24 months	

The general account deposits are categorized according to their periods of maturities. Short-term deposits refer to those not exceeding one year maturity, medium term deposits are those placed for periods between one to three years while those which mature after three years belong to the long-term category. By *mudarabah* investment account depositors are regarded as the *rabb al-mal* (owners of capital) who will bear all financial losses in proportion to the amount of deposits invested. Bank Islam acts as the *mudarib* (user of capital) who is responsible of

investing the deposits in profitable ventures and will share the generated profits with the depositors at an agreed profit-sharing ratio. At present Bank Islam offers the distribution of profits in the ratio of 70 to 30 in favour of the depositors.

Under *mudarabah*, depositors are not allowed to participate in the management of the invested funds. When a deposit is placed in the general investment account it is assumed that the depositor contractually agrees with the existing investment portfolio of the Bank and accepts the fact that not all of the projects in the portfolio may be generating profits. By this agreement Bank Islam is able to organize the depositors' funds into a single pool (as shown in Appendix D) from which they will be utilized into short-term, medium-term and long-term financing and investments irrespective of the terms of deposits. Through this method of central-pooling no project or investment can be individually identified with any individual or groups of depositors or specifically matched with deposits of certain periods of maturity. It allows the Bank to regard the financing and investments undertaken as on-going concerns which can be continuously financed by replacing matured deposits with the incoming deposits. This implies that long-term investments are not necessarily financed by long-term deposits. A succession of short or medium term deposits can be used to fund a long-term investment at different stages of development.

In respect to profit-distribution the principle of *mudarabah* also dictates that profits will only be recognized on a real basis, that is when cash is actually received after an investment venture is completed or "when the legal right to receive it exists"²⁰⁸. The distribution of profits for the investment deposits are explained in detail in Appendix E. As shown in the accompanying table in Appendix E; the distribution of profits are based on the monthly average daily balances and weights

²⁰⁸ Hamat 1985:11.

of ascending order are given in accordance to the periods of maturity. It is logical that deposits of longer terms of maturity should be paid higher rates of profits.

Bank Islam has set the minimum deposit for the general investment accounts at M\$500. On the maturity of their deposits the depositors are given several options by Bank Islam. They can either collect both the principle and any profits realized, collect only the profits and reinvest the principle or reinvest both the principle and the profits for another specified period. However should the investments made by the Bank suffer losses the depositors may get part of his principal or none at all depending on the real amount of loss incurred.

In practice however, Bank Islam exercises prudence to protect the deposits of all its depositors including the general investment account depositors by creating and maintaining general provisions for doubtful financing and investments. These provisions are debited regularly from the gross income derived from the employment of depositors' funds, following the legal opinion of the Hanafi and Maliki schools, at certain percentages as determined by the Board of Directors²⁰⁹. In strict *mudarabah* terms these general provisions should be charged against the profits distributed to the investment account depositors. However on the basis of prudence and conservatism Bank Islam has adopted the policy of charging these provisions against the undistributed profits so that the shareholders will also share the burden of losses with the *rabb al-mal*²¹⁰. By making these provisions the Bank Islam can avoid violent fluctuations in the rates of profits that it actually pays to the depositors and will also be able to give some returns to the depositors in the event of losses.

²⁰⁹ Hamat:15.

²¹⁰ Hamat ibid:16.

Moreover profits derived from all investments of customers' deposits are ploughed back into the central pool to be distributed between the Bank and its depositors. This practice conforms to the legal opinion of the Shafie School. From the point of profits and losses this method reduces the likelihood of losses on the part of the general investment account depositors since high profits in productive sectors can offset any losses incurred by investments in other areas²¹¹.

4. Special Investment Accounts

These accounts are similar to the general investment accounts with the exception that they are reserved for the corporate customers of the Bank and for investments from the government. Since deposits received from these groups of depositors are normally of high net worth they are given special allowances by the Bank. For instance, the period of maturity and the profitsharing-ratios are individually negotiated and if deposits are received on the basis of limited *mudarabah* the depositors may stipulate specific projects or sectors in the economy to which their funds should be invested by the Bank.

6.6.2 Application of Funds

As mentioned in the previous section all the funds received by the bank from its shareholders, and its corporate, government and ordinary customers are placed together in a central pool. These funds are then divided into two categories namely the shareholders funds and the customers' deposits. From here the funds will be disbursed into various forms of financing and investments as permitted by the *Shariah* to generate profit. Basically, the funds from the customers' deposits in each branch are utilized by the branches themselves to extend financing facilities to

²¹¹ Committee Report:29.

its depositors. The financing activities of the branches rest under the management of the Treasury Department at the Head Office.

Broadly speaking the financing activities of Bank Islam fall into the following three main categories;

1. Equity or project financing
2. Term financing
3. Trade financing

The financing facilities are provided to depositors, either individuals or entities, that fulfill the terms and conditions of each type of financing. Generally an eligible applicant must have an account at the bank for a minimum period of six months before application. He must also be a person of good integrity and of sound mind. An eligible entity or a company, on the other hand, is generally required to have opened an account at Bank Islam for at least one year and its business must be lawful from the point of *Shariah*.

6.6.2.1 Project/ Equity Financing

Equity financing refers to the provision of capital by the bank to individuals or entities for the purpose of funding potentially profitable projects either by the principle of *mudarabah* or *musharakah*. Both methods of project financing are available at Bank Islam as shall be explained below.

(a) Mudarabah Financing

These are short and medium term financing of twenty-four months or less, though in practice short-term financing of 1 year is preferred by the bank. *Mu-*

darabah financing may arise, for instance, when a customer (referred to as the contractor) needs an advance to meet his working capital requirements to finance a specific tender from the government or from a well-established company. The bank may grant the contractor 100 per cent financing and have a share in the profits realized under the terms of *mudarabah*. Nevertheless, the contractor must first satisfy the normal eligibility requirements of the bank and must show evidence of his ability to undertake and complete the tendered project without dispute. The feasibility of the project to be undertaken will also be scrutinized.

To appraise the ability of the contractor Bank Islam undertakes a credit analysis which will consider the following factors;

i) the capacity to borrow - This is to ensure that the applicant has been vested the power to borrow, in the case of a limited company by the Board of Directors or by all partners of a partnership.

ii) character/integrity - Since 100% financing is to be provided by the bank, the character of the contractor is the most important criteria in determining the extension of the *mudarabah* facility. Character, in this context, refers to the determination to pay and the bank branch is required to investigate every aspect of the contractor's character. This may be done by seeking character references from relevant parties regarding the contractor's habits, lifestyle, his associates and record of honest dealings. His/her past credit records are also consulted from the contractor's other bankers by making bank enquiries. Bank Islam must be convinced that the contractor will be determined to work hard and complete his contract to his best effort even in adverse condition.

iii) capacity to generate income - If the contractor has a business firm, his

ability can be assessed from the financial and non-financial aspects of the firm. The capacity of the firm to generate income from the financial aspect would be reflected by its liquidity and profitability. The non-financial capacity of the firm to generate income, on the other hand, may be assessed by examining the quality of management, selling prices, costs and expenses, the quality of product and services, the availability of raw material and the effectiveness of its labour force.

When the bank is satisfied with the eligibility of the contractor a deed of assignment between Bank Islam and the contractors would be completed. The deed outlines the details of the *mudarabah* financing facility. These would include the profit sharing ratio mutually agreed between the two parties. This ratio can be 30:70, 40:60 or any other ratios negotiated. The deed also serves as security for repayment of the facility to the bank whereby the contractor agrees that all payments for work done in the project will be paid directly by the third party (the contractee) to the bank. The principal sum of the *mudarabah* financing facility will be deducted by the bank and any excess sum will be distributed between the bank and the contractor according to the agreed ratio. If proceeds are paid in the form of progress payment based on goods and services delivered, the agreed ratio of profit sharing is taken out each time the progress payment is received from the third party and the rest goes to the bank as repayment for the financing facility. In this way the *mudarabah* contract automatically dissolves upon full payment by the third party.

The deed of assignment is then sent to the third party and when receipt is acknowledged, the amount of *mudarabah* funds to be disbursed by Bank Islam to the contractor will be credited to the contractor's account or paid directly to the suppliers of input.

(b) Musharakah Financing

In contrast to *mudarabah* financing where full financing is provided by Bank Islam *musharakah* financing involves capital contribution by both the bank and its prospective partner or partners. Both parties have the rights to participate in the day to day running and the management of the partnership or *sharikat*. The profits of the *sharikat* will be distributed according to a mutually agreed ratio and losses will also be shared in proportion to each party's capital contribution.

At Bank Islam *musharakah* financing can be granted under two arrangements:-

1. On the basis of partnership.

This can be carried out through a joint-account between the bank and its partner(s) without forming any separate legal entity or through the formation of a registered partnership firm. This form of *musharakah* financing is easier and less costly to initiate but it imposes high risks on both parties in the sense that there is unlimited liability. For this reason Bank Islam is generally willing to finance only short-term projects which do not exceed 12 months under this method. In accordance to its policy of prudence and conservatism the Bank extends this form of *musharakah* financing only to its well-known customers who possess good credit worthiness and integrity and also to selected established companies or government corporations with good track records.

2. Through the incorporation of a joint-venture limited company (under the Companies Act 1965).

In this form of *musharakah* financing the bank and the other capital contributors become the shareholders of the company with limited liability. Except for its

high cost of incorporation this method has many advantages. It is suitable for long term ventures (of more than one year) or for projects with long gestation periods because the company can exist indefinitely. Since the company is a separate legal entity the bank can also finance projects which require high initial overhead costs or which need minimum direct supervision and control without running the risk of subjecting its assets to the claims of creditors. For areas in which the bank lacks expertise or prefers non-participation the management of the company can be delegated to a third party while supervision and control can be effectively exercised by the bank through the appointment of representative(s) to the Board of Directors or management team. Among the types of joint-venture companies that Bank Islam is willing to become a shareholder are those which deal in property and real estates, printing, stationery and publication because these businesses conform to the objectives of the bank's corporate taxation policy.

One of the essential aspects of *musharakah* financing pertains to the form and the ratio of capital contribution involved. Under *musharakah* the capital contributions can be in the form of cash or valuable assets. At Bank Islam capital contribution in the form of assets are normally accepted for *musharakah* financing under the joint-venture limited company arrangement.

The most common forms of capital assets accepted by the bank are land, properties, plant and machinery and equipments. For example a partner can contribute his land as capital for a housing development joint-venture with the Bank in return for shares of the company issued under his name.

The capital contribution ratio on the other hand can either be on a 50:50, 60:40, 20:80 or any other ratios depending on the credit standing of the Bank's

partner(s), the degree of risk or control that the bank is willing to undertake as well as the nature of financing required by the partner(s). In the case of bridging finance, for instance, the bank's ratio may be smaller since the partner will be able to improve his cash flow when progress payments for the project are received. However if the bank wishes to have control on the joint-venture then a larger ratio which represents more than 50 per cent capital contribution by the Bank would be more appropriate.

The determination of profits and the profit sharing ratio for *musharakah* financing at Bank Islam will also depend on the entity of the *sharikat*. For the partnership the amount of profit realized can be known periodically from its audited Profit and Loss Account at the end of its financial year. In cases where the value of goods sold can be quantified in terms of sale proceeds and costs at the point of sale profits can be determined at on an ad-hoc basis and distributed at the time of sale of each unit of goods. As for the limited company its audited accounts are normally known several months after the end of its financial year. However if profits can be recognized at the point of sale, (after the sale of housing units for example) profits can be distributed immediately.

The profit-sharing ratio between the Bank and its partner(s) is determined at the time of agreement. It will depend on several factors such as the capital contribution ratio whereby the highest contributor would obviously want the highest share of profits, the extent of management to be undertaken by each partner, the Bank's cost of funds and the Bank's lending guidelines. While the profit-sharing ratio is applicable to short-term ventures and to the partnership it may not be suitable for long-term project financing under the limited company arrangement since it would be difficult to determine profits at intervals. For such projects a

dividend policy is adopted by the Bank whereby part of high profits at any one time can be retained to provide for attractive annual dividends in the future.

There are two types of *musharakah* financing which the bank can undertake with its partner(s). The first is the ordinary *musharakah* by which both parties share the ownership of the venture until it is completed. The other takes the form of *musharakah* ending with single ownership where ownership changes gradually to rest finally in the hands of one party as pre-agreed. In both types the liquidation of the Bank's capital contribution can be settled upon the completion of the project or it may be progressively reduced if the project income is received in terms of progress payments or when units of goods produced are sold.

By the reduction method; in the case of a partnership the Bank's contribution may be reduced at a progressive rate on a redemption basis. Hence when income is received each time the Bank's capital contribution and profit portion is reduced. For a joint-venture limited company a payment schedule may be negotiated in which the Bank's share in the company will be transferred at intervals to its partner(s) so that the Bank's shareholding will be zero at the end of the project period.

6.6.2.2 Term Financing

Besides project financing the customers' deposits are also utilized to provide medium and long-term financing to eligible depositors who wish to acquire fixed assets or use the services of assets over a certain period of time. The funds are also employed for the provision of short-term financing to deserving depositors. The main *Shariah* modes of financing employed by Bank Islam for term financing are *Al-Bai Bithaman Ajil* (Deferred Sale), *Al-Ijarah* (Leasing) and *Al-Qardhul Hasan*

(Benevolent Loan).

(a) Al-Bai Bithaman Ajil

This is a deferred sale contract by which an individual can buy fixed assets from the bank at an agreed price which will be settled at a deferred date either by a lump sum or by instalments.

Al-Bai Bithaman Ajil involves a two step procedure on the part of the bank. The bank will first purchase the asset required by its client. Following this it will sell the asset to the client at an agreed price which would comprise the cost price of the asset and the bank's margin of profit.

At Bank Islam this facility is normally extended for the purpose of acquiring land, new houses, existing houses and shares. The maximum terms of financing also vary in accordance to the asset type; involving twenty years for houses, fifteen years for 'shophouses' and ten years for land. In some cases the duration would be determined by the age factor by which payments have to be settled by the time the client reaches the retirement age of fifty five.

To be eligible for financing the client is required to open an account at Bank Islam preferably six months before application. If repayments are to be made by installments the average monthly credit balance in the account should be sufficient to cover the estimated monthly instalments. A deposit equivalent to the amount of six months installments is also required for long term financing which exceeds five years. The net disposable income of the borrower should also be adequate to pay the monthly installments to avoid undue hardship. A collateral is also needed to ensure that the Bank can fully recover any outstanding amount of the facility in cases of default.

As at 31st January 1991, the rates of profit margin for financing taken by individual customers are set at a flat rate of 8 per cent per year for land, 'shop-houses' and other purposes such as buying shares. For houses the rates vary in accordance to the cost price of the houses paid by the Bank as shown in Table 6.3.

**Table 6.3 — Rates of Profit Margin on al-Bai Bithamin Ajil as at
31.1.1991**

Asset	Cost-price M\$	Bank's Profit Margin
		% per annum
House	≤ 25,000	6
	25,000–99,000	7
	≥ 1000,000	8
Land Shophouse Others	independent of price	8

Source: BIMB data, compiled by the author.

The profit margin for clients in the corporate sectors are determined in accordance to the competitive rates expected in the market.

Until 1990 the repayment schedules for installments were based on the 'sum of year's digits' (SOD) technique. However this method of repayment proves unfair to customers if they wish to redeem their assets after the first few years of the financing period. This is because the rate of repayments decreases (as shown in Appendix F) towards the end of the period which implies that the cost of redemption would be too high for the customers during the initial years. To avoid such injustice the Bank has revised the method of repayment to the current rate

of returns technique in 1991 by which the rates of repayment remain constant over the whole instalment period.

(b) Al-Ijarah

Financing under the principle of *al-ijarah* or leasing is provided by Bank Islam to customers who wish to use the services of certain assets owned by the Bank at a rental rate agreed by both parties. Another variant of leasing which Bank Islam employs is *al-Bai ul Takjiri* or leasing which ends with ownership (hire-purchase). Under the normal *al-ijarah* contract the Bank purchases the asset required by the customer and leases it to him for a fixed period on a lease rental basis. However under the latter mode of leasing both parties would agree that at the end of the rental period the customer will eventually buy the asset from the Bank at an agreed price with all the previously paid lease rentals considered as part of the purchase price.

As at 31 January 1991 the main assets leased by Bank Islam are personal computers for a maximum duration of three years. The customer is also required to pay a deposit equivalent to the amount of five times the rental instalments which would cover a month of rental advance, three months security deposit and a month of prepaid rent for the final month of leasing. The profit margin for the Bank for the leasing services it provides is set at 7.5 per cent per annum.

(d) Al-Qard al Hasan

Literally speaking, *Al-Qard al Hasan* are benevolent loans. The provision of these loans by Islamic banks can be regarded as the discharge of their social responsibility to help the needy. The *Qard al Hasan* scheme at Bank Islam is a new facility which was recently introduced in 1990 at the request of the National Muslim Trust,

the Yayasan Pembangunan Ekonomi Islam Malaysia (YPEIM) which deposited an initial fund of M\$250,000 for this purpose. Under this scheme interest-free loans of up to M\$1,000 can be granted to deserving customers whose monthly household income is M\$250 or less. The main purpose of these loan is to finance small economic projects capable of increasing the income level of the borrowers. A service fee is charged to cover the administrative costs in processing each application.

In line with the target of the new National Development Policy of eradicating hardcore poverty, Bank Islam has also introduced another *Qard al Hasan* scheme since early 1992. The scheme is implemented in cooperation with the *Amanah Ikhtiar Malaysia*, a national trust which extends interest-free loans to poor households to enable them to undertake income-generating activities under close supervision. The role of Bank Islam in this scheme is to provide further interest-free loans to successful 'graduates' of the *Ikhtiar* project as a means to further expand the economic activities initiated with the help of the national trust at the first level. The fund for this scheme is derived from the 'retained zakat fund' of the Bank (which comprises one-eighth of the total amount of zakat paid annually by the bank).

Bank Islam also regards its purchases of the interest-free short-term Malaysian Government Investment Certificates issued under the Investment Act 1983 as benevolent loans to the government. The funds for these loans are derived from the shareholders' funds managed by the Treasury Department of the bank.

6.6.2.3 Trade Financing

The trade financing activities at Bank Islam are managed by the Trade Finance Department. The main users of the trade financing facilities are customers from the

commercial and business sectors who need short-term financing either to facilitate trade such as for the purchase and sale or the import and export of goods and machinery or to acquire working capital in the short-run.

- Letters of Credit

The types of financing that are normally needed to facilitate trade are those connected to letters of credit. These are instruments used to facilitate payments to suppliers through the banks. The normal procedure would require the buyer to place a deposit at the Bank at an amount equivalent to the full price of the purchased or imported goods. The bank would issue a letter of credit and make payments to the supplier through a negotiating bank. A fee is charged by the bank for this service.

Bank Islam uses part of its customers' deposits to provide financing to buyers to settle their letters of credit. The Bank does this by issuing letters of credit under the principle of *musharakah* or *murabaha* . Under the former arrangement the Bank and the buyer become partners in the purchase of the goods. Both parties will make capital contributions to finance the letter of credit which will be issued by the Bank with payments forwarded to the suppliers through the negotiating bank. Hence when the goods arrive from the suppliers they will be sold and profits derived will be shared between the two parties. However if the letter of credit is issued under the principle of *murabaha* or mark-up sale the Bank will buy the goods on behalf of the buyer first by advancing payments to the negotiating bank. On receipt of the goods, it will sell them to the buyer at an agreed price which will include the cost of purchase and the mark-up set by the Bank. The buyer pays the Bank either in full or by installments in the short-run.

- Working capital Acquisition

This facility is provided for traders or producers who require short-run financing to acquire working capital in the form of raw materials, spares and replacements, stock and inventories or semi-finished goods. Financing is provided by Bank Islam under the principle of *murabahah*.

i). The Bank will appoint the trader or producer as its agent to purchase the required goods for working capital on its behalf and settles the purchase price from its own funds.

ii) The goods are subsequently sold to the producer or trader at an agreed price with a profit margin for the Bank. The trader or producer is allowed to settle this sale price on a deferred term normally not earlier than 30 days and not later than 200 days.

iii) The agreed sale price is paid by the customer on the due date.

6.6.2.4 Securitization and Debt Trading

To complement the development of new financial instruments in the interest-based money and capital markets, Bank Islam was allowed to securitize the above working capital financing under *murabahah* through the issue of *al-dayn* debt-certificates. This facility was introduced by Bank Islam in 1991 with the issue of a Bill of Exchange known as the Islamic Accepted Bill (IAB) to finance credit import and export as well as domestic sales.

The IAB is the Islamic version of the Banker's Acceptance (with the exception of interest) whereby it is drawn by an exporter/supplier and accepted by Bank Islam or any other bank which is the drawee or acceptor of the IAB.

The procedures for accepting and repurchase of the IAB can be briefly described as follows:-

- Accepting Procedure

i) The exporter presents the export bill to the Bank to arrange for financing up to the full amount of the value of the exported goods. The Bank will in turn undertake to collect the proceeds of the export bill and obtains authorization from the exporter to have control over the bill and its proceeds until the financing has been repaid by the exporter.

ii) An IAB, with a maturity period not longer than 200 days, is drawn by the exporter and accepted by the Bank. The Bank then purchases the IAB and credits the proceeds to the account of the exporter.

iii) The Bank would have received the proceeds of the export bill before the day the IAB matures so that it can discharge the IAB. If the export bill is not settled by the prescribed date of maturity the Bank may either repurchase the IAB or obtain other funds from the exporter to settle the discharge of the IAB.

- Repurchase Procedure.

The IAB is traded in the secondary market through repurchase agreements (Repos). Any financial institution may sell the IABs with a separate agreement to repurchase them at an agreed price on a specified future date. On the other hand, it may buy IABs with a separate agreement to resell them at a specified future date. However the period of the repurchase agreements should not exceed the maturity date of the IAB and the IAB cannot be sold on a call

basis. Upon the maturity of the IAB, the holder will present the IAB through his bank to the accepting bank for payment through the Clearing House.

Bank Islam may also resell the IAB to the Central Bank if the items to be exported meet the list of goods and other guidelines of the Central Bank under its export-promoting “Export Credit Refinancing Scheme” to take advantage of the special terms of this scheme.

Following the success of the Cagamas bonds issues, Bank Islam has also competed in the market to lead-manage the issue of Islamic debt certificates by a leading oil-company. This facility was syndicated among ten participating institutions with Bank Islam acting as lead manager to provide a deferred-sale *al-bai Bithamin Ajil* financing facility to a leading oil company for the purchase of equipment for its local refinery. The financing facility was securitized under the concept of *Bai’ al-Dayn* (debt trading) whereby the oil company issued a series of promissory notes known as *Shahadah al-dayn* certificates with amounts and maturity dates according to the repayment schedules of the financing to the participants of the syndicate. These notes may be traded in the secondary market under the repurchase agreements facility.

6.6.2.5 Other Uses of Funds

Excess funds received by the Treasury Department from its branches and a portion of its shareholders’ funds are also used to bridge the funds of any branches experiencing temporary shortages. When these funds are transferred to the affected branch they are considered as investment deposits called 12-month Investment Account Deposits and are callable on demand. The relevant branch is required to return the funds when its situation improves, plus the prevalent ratio of profits

for these deposits for the number of days they are held.

6.6.2.6 Investment

Part of the shareholders' funds and customers' deposits is managed by the Investment Management Department. These funds were to be utilized in the following types of investment under the *musharakah* arrangement.²¹²

1. setting-up wholly-owned subsidiaries
2. taking up equity as a shareholder in unquoted companies
3. purchase of shares in public companies quoted on the KLSE for long-term investment
4. portfolio investment in shares of public companies quoted on the KLSE. This investment is managed by the Bank's subsidiary, Al-Wakalah Nominees Sdn Berhad, that also provide portfolio investment services to its customers for a fee.

6.6.2.7 Other Banking Operations

The Bank also undertakes fee-based activities such as foreign exchange transaction, letter of credit, letter of guarantees, remittances, sale of travellers' cheques, portfolio management and nominee company services in return for fees and commission. These do not involve the use of the customers' deposits. Other income is also derived from the fees on returned cheques and on financing and loan processing.

²¹² Ismail 1992:68

6.6.2.8 Maintenance of Statutory Reserves and Liquid Assets

Like the other commercial banks in Malaysia Bank Islam is required to fulfil the statutory reserve and liquidity requirements set by the Central Bank. Hence one of the important functions of the Treasury Department is to manage the statutory reserve for the whole Bank by ensuring that each branch complies with the level of statutory reserves required against its total deposits every fortnight. The statutory reserve requirement for the whole Bank will be placed by the department with the Central Bank using the funds maintained by all branches.

To fulfil the Central Bank liquidity requirements the Treasury Department is also responsible to manage the liquid assets for the whole bank as required by the Central Bank. These liquid assets are held in the form of

- (a) Cash-in-till at all branches
- (b) Balances with local banks, agent banks and correspondent banks for clearing, remittances and letter of credit purposes.
- (c) Balances with the Central Bank
- (d) Malaysian Government Investments Certificates
- (e) Other forms of liquid assets allowed by the Central Bank from time to time.

6.7 Conclusion

This chapter has shown that the favourable political climate has played a major role in leading to the establishment an Islamic bank in Malaysia. The Malay-led government had the political will to respond to the demands for Islamic bank-

ing services by Muslims who form the majority of the electorate. In view of the Malay/Muslim underdevelopment the establishment of the Bank may not have been possible without the financial support from the government. The operational framework of the Bank outlines an extensive range of banking services in compliance with the *Shariah*. These include equity-participation and profitsharing as recommended in theory, trade-related services based on the markup and the issue of new financial instruments to keep pace with the current development in the Malaysian money and capital markets. The extent to which these banking services have been fully utilized by Bank Islam in the mobilization of deposits and the allocation of its resources will be examined in the following chapter.

Chapter VII

The Performance of Bank Islam

7.1 Introduction

Whilst the overall profile of Bank Islam was described in the previous chapter, the main concern of this chapter is to evaluate the performance of Bank Islam in terms of its viability as a financial intermediary in the economic sense as well as its performance as an Islamic bank from the Islamic economic perspective. The main thrust is to examine the extent to which the Bank has succeeded in offering an alternative form of banking in a well-established interest-based environment. As recognized in Chapter V, at the time Bank Islam was introduced in 1983 there were already 23 locally-incorporated commercial banks and another 15 foreign banks in the market. In addition specialized development finance institutions were already serving the financial needs of the Malay/Muslim community to achieve the restructuring target of the NEP. Our aim therefore is to find out the impact of Bank Islam in the mobilization of interest-free deposits in such an environment. On the other hand, given that Bank Islam has been set up specifically as a commercial bank (as declared in its corporate objective), the main question that arises is whether the Bank has directed its funds purely to achieve the economic objective of profits or does its Islamic character differentiate it from the other commercial banks in the country? This chapter is divided into four main sections. Section 2 will examine the relative position or the market share of Bank Islam within the domestic banking system. Sections 3 and 4 will study the performance of Bank

Islam in the execution of its function as a financial intermediary specifically in the mobilization of deposits and the utilization of funds. Finally an evaluation of the Bank's financial performance will be undertaken in Section 5.

7.2 Market Share of Bank Islam

In view of its position as the only Islamic bank in Malaysia, the market share of Bank Islam relative to the other domestic commercial banks in the Malaysian banking system would be the first indication of its significance to the economy. As a new comer into the banking system one would not expect the Bank to occupy a large share of the market. However a growing market share would be a good sign of its performance and its viability in the 'hostile' environment.

Tables 7.1 and 7.2 show the market shares of Bank Islam in relation to the other locally incorporated commercial banks in Malaysia in terms of certain indicators for the years 1984 and 1989²¹³ respectively. A comparison between both tables reveals that:-

- The growth of its assets over the past eight years has transformed Bank Islam from being one of the smallest banks in 1984 to a medium-sized bank in 1989. The assets of Bank Islam were worth M\$563 million in 1984. This represented a negligible 0.8 per cent of the total assets of the domestic commercial banks in 1984. By 1989, its assets had grown to M\$1.7 billion which expanded its market share to 2 per cent and placed it as the thirteenth largest commercial bank joining the ranks of five other banks of similar assets size. This is a commendable performance in the sense that apart from becoming a medium sized bank, Bank Islam was also the top bank in its peer group and has also

²¹³ This is the latest data available in the Kuala Lumpur Bankers Directory.

**Table 7.1 — Commercial Banks (locally incorporated): Assets,
Deposits, Shareholders' Funds & Profits as at 31 December 1984**
(M\$'000)

Name of Institution	Assets		Deposits		Shareholders' Funds		Net Pre-tax/After Tax + (Profit/Loss)	
	Size	Ranking	Size	Ranking	Size	Ranking	Size	Ranking
Malaya Banking Berhad****	22,067,881	1	14,066,847	2	1,132,053	1	121,343+	1
Bank Bumiputra Malaysia Berhad	21,102,385	2	14,657,965	1	1,074,469	2	(78,474)	23
United Malayan Banking Corporation Berhad*	7,494,271	3	4,517,494	4	200,911	4	30,599	3
Public Bank Berhad	5,811,853	4	4,785,041	3	319,047	3	21,089	7
Development and Commercial Bank Berhad	4,154,034	5	2,999,118	5	174,496	5	32,681	2
United Asian Bank Berhad*	3,543,871	6	2,161,914	6	132,655	6	9,401	9
Perwira Habib Bank Malaysia Berhad	2,346,128	7	1,844,733	7	76,443	8	(18,863)	22
Malayan United Bank Berhad	1,540,000	8	1,262,000	8	75,000	9	25,800	5
Kwong Yik Bank Berhad	1,341,262	9	1,090,175	9	72,744	11	23,260	6
Hock Hua Bank Berhad	1,313,330	10	973,370	10	74,380	10	27,130	4
The Pacific Bank Berhad	1,073,118	11	608,604	15	46,010	14	12,754	8
Southern Bank Berhad	1,050,906	12	799,162	11	68,976	12	8,987	10
Bank Utama (Malaysia) Berhad	1,026,600	13	725,334	13	38,163	17	6,051+	14
Sabah Bank Berhad*	844,688	14	657,873	14	39,590	15	1,005	19
The Oriental Bank*	838,795	15	731,953	12	38,127	18	2,955	17
Bank of Commerce Berhad***	762,055	16	478,064	16	25,348	21	1,653	18
Malaysia French Bank Berhad	731,467	17	307,380	18	46,559	13	7,867	12
Bee Hin Lee Bank Berhad	684,315	18	472,634	17	38,608	16	6,404	13
Bank Islam Malaysia Berhad**	563,429	19	241,355	19	80,364	7	(1,286)	21
Hock Hua Bank (Sabah) Berhad	307,107	20	215,348	20	26,213	20	8,358	11
Wah Tat Bank Berhad	215,307	21	163,812	21	13,480	22	4,080	15
Kong Ming Bank Berhad*	180,217	22	154,797	22	11,929	23	3,096	16
Bank Buruh (Malaysia) Berhad****	167,759	23	68,868	23	28,213	19	438	20

* Position as at 31 December 1983.

** Position as at 30 June 1984.

*** Position as at 31 August 1984.

**** Position as at 30 June 1985.

+ Including Contra Accounts

SOURCE: Arab-Malaysia Merchant Bank Berhad, *The Kuala Lumpur Bankers Directory*, 1986.

• Bank Islam Malaysia, Annual Report 1984

**Table 7.2 — Commercial Banks(locally incorporated): Assets,
Deposits, Shareholders' Funds & Profits as at 31 December 1989**

(M\$'000)

Names of Institutions	Assets+		Deposits		Shareholders' Funds		Net Pretax/After Tax# Profit/(Loss)	
	Size	Ranking	Size	Ranking	Size	Ranking	Size	Ranking
Malayan Banking Berhad***	33,533,180	1	22,744,892	1	1,257,232	1	181,884	1
Bank Bumiputra Malaysia Berhad**	30,694,305	2	20,458,244	2	(106,435)^	22	(1,044,431)	23
United Malayan Banking Corporation Berhad*	10,654,565	3	6,427,852	4	503,846	3	25,620	5
Public Bank Berhad	9,502,933	4	7,179,081	3	551,042	2	86,026	2
Development And Commercial Bank Berhad	6,973,793	5	4,321,125	5	370,215	4	15,697	9
United Asian Bank Berhad*	3,964,319	6	2,174,563	6	74,907	11	26,680	4
Perwira Habib Bank Malaysia Berhad	3,114,825	7	1,832,168	8	(241,221)	23	15,626	10
Kwong Yik Bank Berhad***	2,743,767	8	1,879,883	7	133,484	6	(9,508)	22
Bank of Commerce Berhad****	2,727,482	9	1,725,975	10	105,077	8	19,840	7
Southern Bank Berhad	2,532,262	10	1,674,444	11	174,490	5	39,026	3
Malaysian French Bank Berhad	2,319,099	11	1,033,106	15	61,679	14	11,767	12
MUI Bank Berhad	2,234,696	12	1,732,015	9	87,402	9	16,051	8
Bank Islam Malaysia Berhad***	1,713,878	13	1,229,234	12	84,680	10	11,640	13
Hock Hua Bank Berhad*	1,524,231	14	1,170,806	13	109,518	7	23,290	6
Oriental Bank Berhad*	1,514,905	15	921,576	18	(10,682)	21	5,122	16
The Pacific Bank Berhad	1,490,983	16	970,766	16	64,013	13	13,574	11
Ban Hin Lee Bank Berhad	1,434,645	17	1,078,283	14	71,268	12	5,760	15
Bank Utama (Malaysia) Berhad*	1,230,210	18	970,145	17	30,902	18	(4,216)	21
Bank Buruh (Malaysia) Berhad***	655,265	19	429,422	20	35,952	16	2,602	20
Sabah Bank Berhad*	629,370	20	512,667	19	31,828	17	8,776	14
Kong Ming Bank Berhad*	453,924	21*	387,572	21	16,423	20	2,985	19
Hock Hua Bank (Sabah) Berhad*	310,294	22	226,059	23	36,571	15	4,654	17
Wah Tat Bank Berhad*	301,385	23	249,692	22	18,256	19	3,682	18

+ Including Contra Accounts

* Position as at 31st December, 1988

** Position as at 31st March, 1989

*** Position as at 30th June, 1989

**** Position as at 31st August, 1989

^ Shareholders' funds increased to M\$1,176 million by 31.12.89.

SOURCE: Arab-Malaysia Merchant Bank Berhad, *The Kuala Lumpur Bankers Directory*, 1990

surpassed the more established medium-size banks such as the Hock Hua and Pacific banks which were ranked tenth and eleventh in 1984 but have moved to lower positions in 1989.

- The most remarkable growth for Bank Islam is its market share of deposits which expanded from 0.7 per cent of total domestic bank deposits in 1984 to 2.4 per cent in 1989. Bank Islam was ranked nineteenth in 1984 with total deposits amounting to M\$241 million relative to the domestic industry total of M\$35 billion. By 1989, its deposits had risen by almost 400 per cent to M\$1.2 billion. With a greater market share its relative position in the domestic market had also improved to the middle twelfth position in 1989.
- In terms of its capital base, it is evident that the Bank's shareholders' funds increased only by 5.3 per cent during the period; from M\$80.3 million in 1984 to M\$84.7 million in 1989. This rise was mainly generated by the increase in the Bank's reserves while its paid-up capital remained constant. Because of the small increase, the Bank's market position, in terms of its shareholders funds, was relatively lower in 1989 - from seventh in 1984 to tenth in 1989. (However as described in Chapter VI, the paid-up capital of Bank Islam was increased to M\$133.4 million in January 1992 which was likely to have improved its market position considerably.)
- In terms of profitability, Bank Islam incurred a pre-tax loss of M\$1.3 million at the end of its first financial year in 1984. However, the Bank was able to breakeven within a year and earned a profit of M\$4.4 million ringgit in 1985. The Bank has in fact been profitable every year since then. In 1989 its pre-tax profits were recorded at M\$9.9 million placing it among the thirteen

most profitable banks in Malaysia. It is also worth noting that Bank Islam came into operation at a time when the Malaysian economy was in a recession. As noted earlier in Chapter V, several shocks have hit the banking system between 1985 and 1987. The collapse in property prices in 1986 was the biggest plight which left many commercial banks with large amounts of bad and non-performing loans. Several banks were rescued from closure by the Central Bank and a number of finance companies and deposit-taking co-operatives were taken under receivership. Bank Islam was also reported to have had its share of non-performing loans; in fact a little more than the other banks in the beginning of its operations.²¹⁴ However, the ability of Bank Islam to survive and remain profitable despite the unfavourable market environment is a significant indication of its viability. As can be seen in Table 7.2 the profits of Bank Islam in 1989 have surpassed that of some of the bigger banks (for example Bank Bumiputra, Bank Utama and Kwong Yik Bank which suffered losses).

It can be deduced from the above figures that, except for its capital base, the market shares of Bank Islam have expanded considerably over the first six years of its operations. Whilst the market share of its assets has increased from 0.8 per cent in 1984 to 2 per cent in 1989, its market share of deposits has expanded from 0.7 per cent in 1984 to 2.4 per cent in 1989. Obviously, the market share of Bank Islam is relatively marginal compared with the industry total. Nevertheless it is also worth noting that many of the other domestic banks are also small in size. Whilst the largest share of the market is dominated by the two top banks (Malayan Banking and Bank Bumiputra), which together accounted for 74 per cent of total assets and 83 per cent of total deposits in 1989, Table 7.2 shows that sixteen banks

²¹⁴ Malaysian Business June 1991:10.

(69.5% of total domestic banks) had assets which accounted for 3 per cent or less of the domestic industry total in 1989. Each of these banks also accounted for less than 4 per cent of total deposits mobilized by the domestic banks. Looking from this perspective, the market share of Bank Islam is not insignificant compared with the other small banks.

In summary the 'middle' position of Bank Islam and the growth of its market shares are encouraging signs which suggest the potential of Islamic banking in the Malaysian economy. Nonetheless, the performance of Bank Islam cannot be evaluated in term of its market share alone. Equally important is to judge its performance in terms of its growth and functions as a financial institution promoting the novel concept of interest-free banking in a well-established interest-based market.

It is worth noting that the declared corporate objective of Bank Islam is '*to operate as an Islamic commercial bank functioning on the basis of Islamic principles, providing banking and financial facilities and services with viability and capability to sustain itself and grow in the process*'²¹⁵

On the basis of the above objective the aim of the following sections is to examine the success of Bank Islam in its operation as an Islamic commercial bank specifically in the mobilization of funds from the surplus units and the disbursement of these funds through the various methods as described in the previous chapter.

7.3 Mobilization of Deposits

Given the Malaysian environment in which the financial market is being mo-

²¹⁵ Ismail 1982:58.

nopolized by interest-based banks and where the population has developed a certain degree of financial habits, it is pertinent to evaluate the success of Bank Islam in promoting the concept of interest-free deposits and profit sharing as an alternative to interest. Among the appropriate performance indicators are the growth and structure of deposits, the distribution of depositors and the expansion of branch network.

7.3.1 Growth of Deposits

One way to evaluate the success of Bank Islam in deposit mobilization is to examine the growth of its deposits. The size and growth of deposits are integral to any commercial bank since deposits constitute the main source of funds to finance income-generating financing and investment activities. The expansion and future development of a commercial bank therefore depends very much on the continuous growth of its deposits.

Table 7.3 and Figure 7.1 show the size and the growth of total deposits over the first eight years of Bank Islam's operation. In general the growth of total deposits has undergone three distinct periods.

The first period, between 1983 and 1985, may be identified as a period of high deposit growth as indicated by the dramatic rise in deposits by 165 per cent per annum during the last six months of the first financial year before slowing down to a high rate of 70 per cent per year at the end of the second financial year. The second period which lasted between July 1985 and June 1988 represented an interval of moderate growth as deposits increased between 20 and 43 per cent per year. The third period, however, showed a time of declining growth when deposits contracted by 0.7 per cent in 1990 and further down by 3.8 per cent in 1991.

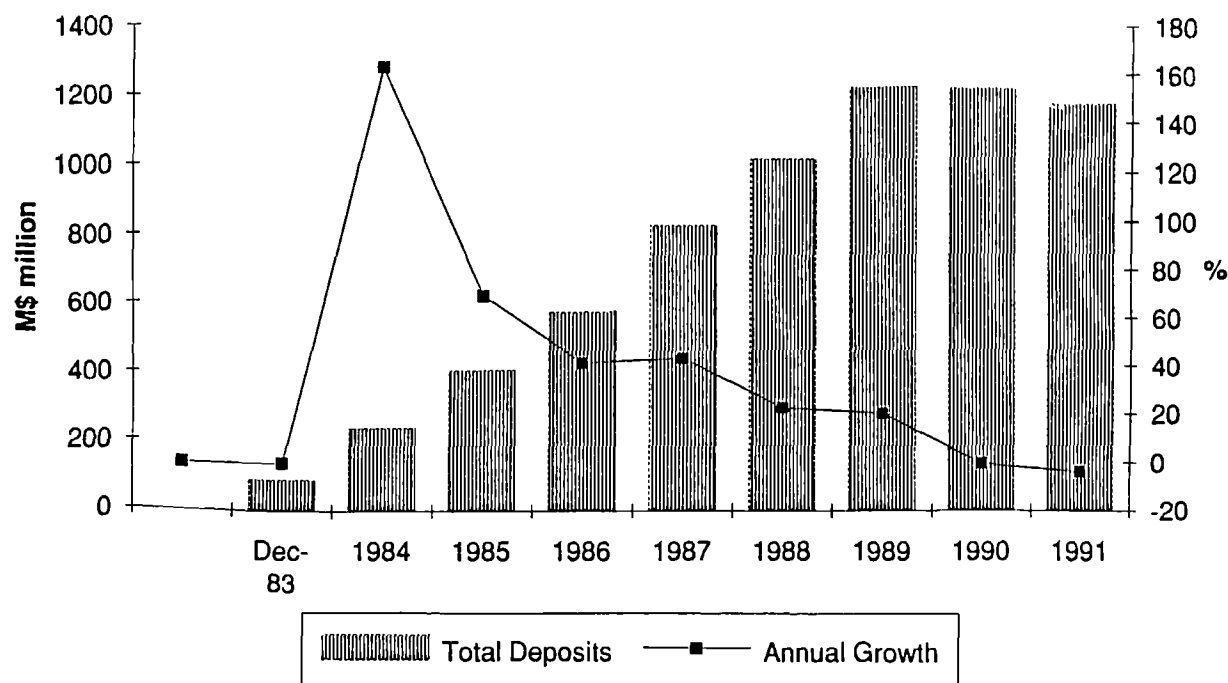
Table 7.3 — Bank Islam: Total Deposits and Growth Rate 1984-1991

Financial Year (as at 30th June)	Total Deposits M\$ million	Annual Growth (%)
December 1983	91.0	0.0
1984	241.3	165.0
1985	410.2	70.0
1986	581.2	41.7
1987	833.7	43.4
1988	1022.2	22.6
1989	1229.2	20.2
1990	1220.9	-0.7
1991	1175.1	-3.8

Source: Bank Negara Annual Report 1983, BIMB unpublished data 1984-1987, BIMB Annual Reports 1988-1991.

The substantial growth of total deposits during the first two years signified two important points. Firstly, it indicates that there was a positive response from the public to the setting up of the Islamic bank. Apart from the motivation to avoid *riba* amongst pious Muslims, the high response was also instigated by the high publicity surrounding the establishment of the bank. The official opening of its first branch by the Prime Minister, (who also became the first account holder) had effectively promoted public confidence and drew a lot more depositors than was anticipated. This high confidence was reflected by the fact that more than 2,000 accounts were opened in the first four days of business. The large stream of depositors suggested that there was indeed a gap in the market for interest-free banking for Muslims including those who were not necessarily motivated by the religious factor in the first place.

**Figure 7.1 — Bank Islam: Total Deposits and Annual Growth
(1984-1991)**



Secondly, it can be deduced that the substantial growth of deposits was largely attributed to the religious motivation rather than the motive to earn. This is based on the observation that the growth of deposits was not affected by the rates of interest on deposits offered by the interest-based banks.

As shown in Table 7.4, the rates of interest on conventional bank deposits were much higher than the rates of profits offered by Bank Islam on its savings and investment deposits. The interest rates on savings were 7.5 per cent per annum in 1984 and 1985 compared to the 5 per cent profits on savings offered by Bank Islam. Similarly the rates of interest on fixed deposits varied between 8 per

cent and 10.75 per cent per annum whilst the highest rate of profit on investment deposit was only 7.25 per cent per year during both years. Even though interests on conventional bank deposits were much higher than the rates of profits offered by Bank Islam, the flow of deposits into the new bank did not seem to be affected by this factor. As mentioned earlier outstanding deposits at the end of the first financial year stood at M\$241 million of which M\$91 million were mobilized within the first six months alone. This was followed by a rapid rise of 70 per cent at the end of the second financial year with total outstanding deposits at M\$410 million.

**Table 7.4 — Rates of Profit and Average Interest Rates on Deposits,
1984-1985 (% per annum)**

Type of Deposit	Bank Islam		Conventional Banks	
	Dec 1984	Dec 1985	Dec 1984	Dec. 1985
Savings	5.14	5.18	7.50	7.50
Investment/Fixed	General	Investment	Fixed	Deposit
1 month	5.76	5.80	10.00	10.50
3 months	6.12	6.17	10.50	8.50
6 months	6.48	6.53	10.50	9.00
9 months	6.84	6.89	10.50	9.00
12 months	7.20	7.25	10.75	9.00

Source: Man (1986) Table 4.3 & Table 4.5

It is apparent that a majority of depositors who saved or invested at Bank Islam between 1983 and 1985 were indifferent towards the higher rates of interest on deposits at traditional banks. It seems that these depositors were religiously motivated in that they were willing to earn a lower but legitimate rate of return on their deposits. The substantial amount of deposits mobilized also suggests that

considerable amounts of idle funds had been kept outside the financial system prior to the establishment of Bank Islam. It can therefore be deduced that the rapid growths in deposits in the first two years tend to be more closely associated with the religious rather than the rate of return factor.

Table 7.5 — Annual Growth of Deposits by Type 1985-1991

Type of Deposit	Annual Growth (%)						
	1985	1986	1987	1988	1989	1990	1991
BANK ISLAM							
Current	7.8	31.6	117.3	54.0	-7.5	51.2	13.0
Savings	78.0	68.2	45.5	34.3	18.8	17.6	17.0
Investment ¹	83.2	40.0	34.0	23.9	25.9	-25.1	-11.5
Total Deposits	70.0	41.7	43.4	22.6	20.2	-0.7	-3.8
COMMERCIAL BANKS							
Current	-1.7	-4.4	18.7	13.9	27.2	17.7	10.8
Savings	12.9	14.7	42.8	15.6	9.5	3.7	-2.4
Fixed	9.3	6.5	-9.8	0.5	10.9	-1.1	37.5
NCD	18.7	14.7	42.8	15.6	9.5	3.7	15.0
Total Deposits	8.7	7.4	5.1	6.1	13.8	10.1	16.5

Note:¹ includes special investment deposits.

Source: Bank Islam Annual Reports, Bank Negara Annual Reports 1985-1991

After the initial upsurge, the trend in deposit growth took a different course in the next six years between 1986-1991. As shown earlier in Figure 7.1, even though there were absolute annual increases in the amount of deposits mobilized, a noticeable declining trend in deposit growth can be observed in terms of percentages. These small percentages may be partly due to the large deposit base but it is also noticed that the slowing down in deposit growth was also caused by other forces.

At the outset, the smaller increase in total deposits was largely attributed to the impact of the economic recession which was at its worse between the second half of 1985 and throughout 1986. A look at the growth rates of the different types of deposits reveals a general decline across the board in 1986. As can be seen in Table 7.5, the growth of both savings and investment deposits were much lower in 1986 relative to their rates in the previous year. Whilst the rise in savings declined by 10 per cent, the growth in investment deposits registered a large fall of 43 per cent. The decline in business activity was also reflected in the current account deposits which grew only by 31.6 per cent from 7.8 per cent in 1985.

The slow down in deposit growth was experienced not only by Bank Islam but also by the entire commercial banking industry. As Table 7.5 shows, total deposits of the interest-based commercial banks declined in 1986 as fixed deposits grew only by 6.5 per cent and current account deposits contracted by 4.4 per cent reflecting the sluggish growth in income throughout the economy as a result of the decline in export prices and the austerity drive by the government (as described earlier in Chapter IV).

The rate of growth in total deposits improved in 1987 showing a rise of 43 per cent. As evident in Table 7.5 much of this increase was caused by a substantial rise in current account deposits which recorded a growth of 117 per cent. This was in line with the upward trend of 18.7 per cent in the current account deposits of the interest-based banks. Since current accounts are normally used for transaction purposes and are mostly held by the corporate sector the high growth of these deposits reflected the increase in business receipts following the revival of business activity as the economy began to show signs of recovery in 1987.

It is interesting to note however that as the Malaysian economy continued to strengthen and the growth of total deposits in the commercial banking system has improved to double digits since 1989, the expansion of Bank Islam's deposit base was relatively slower and was in fact stationary in 1990. According to the management of Bank Islam the decline in deposit growth was mainly attributed to the decline in the amount of investment deposits as a result of the rapid rise in the interest-rates offered on fixed deposits by the conventional banks. As stated in the Bank Islam Annual Report 1990, the fall in the volume of investment deposits was "mainly due to the fact that during the year the Bank's rates of profits on its investment accounts were becoming less attractive when compared with the rapidly increasing rates of interest paid by the conventional banks".²¹⁶ A comparison between the rates of profits on Bank Islam investment deposits and the rates of interest on fixed deposits offered by the conventional bank as well as the growth in investment deposits supports the above statement.

As shown in Table 7.6 and Figure 7.2, there seems to be an inverse relationship between the growth of Bank Islam investment deposits and the rates of interest on fixed deposits between 1986 and 1991. Unlike the trend in the first two years, when investment deposits rose tremendously despite the lower rates of profits, the growth of investment deposits was higher during the recession of 1986 and in 1987 and 1988 when the rates of profits offered by Bank Islam were higher than the 12 months interest-rates on fixed deposits. However when average interest rates exceeded the profits of investment deposits in 1989 the growth of these deposits began to slow down and dropped drastically as the margin between interest and profit widened in 1990 and 1991.

²¹⁶ BIMB Annual Report 1990:43.

**Table 7.6 — BIMB & Commercial Banking Industry: 12 Month
Deposits - Returns & Annual Growth (1985-1991)**

Type of Deposits	1985	1986	1987	1988	1989	1990	1991
Investment/Fixed	Yields & Annual Growth (%)						
Yields:							
Profits	7.5	6.7	5.9	4.6	4.5	5.0	5.4
Interest	7.25	7.0	4.2	4.2	5.1	6.0	8.0
Annual Growth:							
Investment Deposits	83.2	40.0	34.0	23.9	25.9	-25.1	-11.5
Fixed Deposits	9.3	6.5	-9.8	0.5	10.9	-1.1	37.5

Source: BIMB Annual Reports 1985-1991, Bank Negara Annual Reports 1985-1991

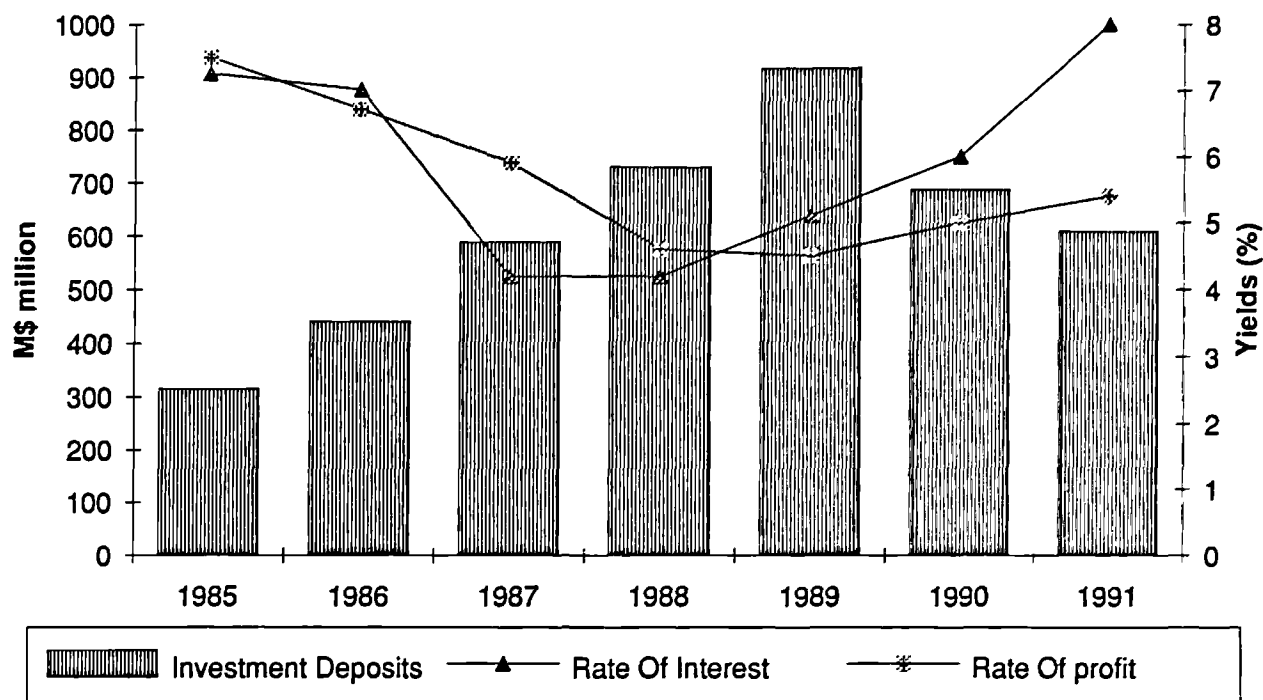
Depositors' behaviour in anticipation of rising interest rates was reflected in the high preference for short-term investment deposits especially those that mature within 3 to twelve months which would enable the depositors to shift their funds out of Bank Islam on maturity. Since 1988, about 95 per cent of total investment deposits were due within a year. Hence when interest-rates on fixed deposits of 1-12 months increased to an average range of 6-7.5 per cent per year in 1990, it was observed that maturing investment account deposits, in particular those belonging to institutional depositors were not reinvested.²¹⁷ As a result the growth of investment deposits fell from 25.9 per cent in 1989 to minus 25.1 per cent in 1990 and further down to minus 11.5 per cent in 1991.

This recent trend in deposit growth indicates several points.

i) After the idle resources prior to the establishment of Bank Islam have been absorbed during the initial years, further mobilization of investment deposits be-

²¹⁷ Bank Negara Annual Report 1990.

Figure 7.2 — BIMB & Commercial Banking Industry: 12 Month
Deposits - Yields & Annual Growth



yond the pious group would depend more on the expected rates of returns rather than on the religious motivation to avoid *riba*.

ii) The rates of return for deposits based on profits are much higher than the the rates of return based on interest during the recession which suggests that the former is relatively more stable and adjusts more easily to the economic recession.

iii) Depositors tend to compare the returns on deposits between the two systems which means that the Islamic bank in a monopolistic Islamic sector does face competition for deposits from the interest-based banks.

iv) The average rate of return on deposits has not been very competitive. Even

though the rates of profit on investment deposits have increased since 1989 the rise was not sufficient to match the rapid rise in the rates of interest offered by the other commercial banks hence resulting in a decrease in the Bank's deposits base.

7.3.2 Structure of Deposits

Table 7.7 and Figure 7.3 show that the bulk of total deposits is made up of investment accounts. On average investment deposits accounted for 74 per cent of total deposits in the 1980s but have declined to 54 per cent in 1990-1991 because of the competition from the fixed deposits of the interest-based banks. As noted earlier, a majority of these deposits were held in the short-term. Even though Bank Islam offers to accept investment deposits at varying rates of maturities ranging from one month to five years, in reality 90 per cent of these deposits were placed for a period of one year or less.

The ratios of the savings and current account deposits to total deposits were almost equivalent throughout the period. The volume of savings deposits has grown more than nine folds from M\$26 million in 1984 to M\$249 million in 1991. These deposits accounted for less than 15 per cent of total deposits in the 1980s but have increased their share to 21.2 per cent in 1991.

Table 7.7 — BIMB: Structure of Deposits 1984-1991

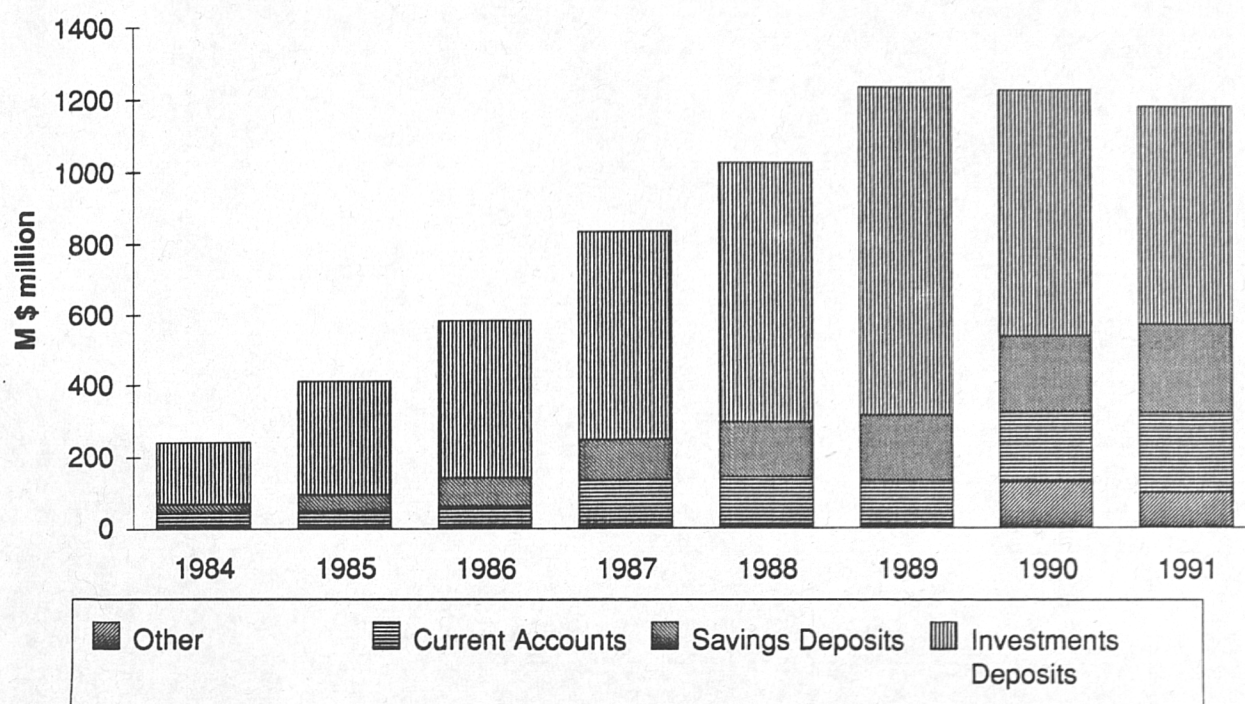
Type of Deposit	Amount (M\$ million) as at 30 June							
	1984	1985	1986	1987	1988	1989	1990	1991
Current	39.9	43.0	56.6	123.0	139.4	129.0	195.0	220.0
Savings	26.1	46.5	78.2	113.8	152.8	181.5	213.4	249.5
Investment ¹	172.2	315.4	441.0	588.9	729.4	918.1	688.1	609.2
Other	3.1	5.3	5.4	8.0	0.6	0.5	124.4	96.1
Total	241.3	410.2	581.2	833.7	1022.2	1229.1	1220.9	1175.1
Type of Deposit	Percentage of Total(as at 30 June)							
	1984	1985	1986	1987	1988	1989	1990	1991
Current	16.6	10.5	9.7	14.8	13.6	10.5	16.0	18.8
Savings	10.8	11.3	13.5	13.6	14.9	14.8	17.4	21.2
Investment	71.3	76.9	75.9	70.6	71.4	74.7	56.4	51.8
Other	1.3	1.3	0.9	1.0	0.1	0.0	10.2	8.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: ¹ includes special investment deposits.

Source: BIMB unpublished data 1984-1987, BIMB Annual Reports 1988-1991

The proportion of current deposits to total deposits has also been increasing steadily over recent years from 10.5 per cent of total deposits in 1989 to 18.8 per cent in 1991. Prior to 1989, the shares of these accounts have fluctuated in tandem with the growth pattern of the economy. The shares of current accounts in total deposits were very low during the 1985-1986 recession - the lowest was recorded in 1986 with a share of 9.7 per cent of total deposits (Table 7.7). As the economy recovered in 1987, the proportion of current deposits in the total also increased to 14.8 per cent during the same period. As noted earlier, this trend may be explained by the fact that the current accounts at Bank Islam were generally held by the government and statutory authorities and business enterprises for transactional

Figure 7.3 — BIMB: Structure of Deposits 1984-1991



purposes. Hence when business receipts declined during the recession, the ratio of current account deposits to total deposits also fell. On the other hand, the large increase in the share of these deposits in 1987 was largely attributable to the increase of business receipts following the revival of economic activities during the year.

Intra-industry and inter-bank comparisons show that the deposit structure of Bank Islam compared favourably with the industry norm and the deposit structure of other medium-sized conventional banks.

As can be seen in Table 7.8 the respective shares of Bank Islam's current and savings accounts to total deposits, (16% and 17.4% respectively) for the 1990

financial year, were close to the industry figures (18.2%, 16.3% of total deposits respectively). In fact the Bank's share of investment deposits (56.4% of the total) was higher than the industry's share of fixed deposits.

The distribution of Bank Islam deposits was also comparable to the deposit structures of two other banks of similar size, with the exception of savings deposits where the Bank Islam figure is relatively lower. Its share of current account to total deposits however, was in close proportion to that of the Hock Hua Bank while the share of investment deposits in the total can be compared with the proportion of fixed deposits mobilized by the Ban Hin Lee Bank.

Table 7.8 — Deposit Structure: Bank Islam, Medium-Size Banks & Industry. (1990 Financial Year)

Bank	Percentage of Total Deposits (%)				
	Current Account	Savings Account	Investment Account	Fixed Deposit	Total Deposits: Due within 1 year
Industry	18.2	16.3		41.0	<i>not available</i>
Bank Islam	16.0	17.4	56.4		94.5
Ban Hin Lee	17.3	20.5		58.5	84.0
Hock Hua	20.7	24.6		53.6	94.1

Source: Bank Negara Annual Report 1990, BIMB Annual Report 1990, Ban Hin Lee Bank Annual Report 1990,

Hock Hua Bank Annual Report 1990.

7.3.3 Depositors

The total number of Bank Islam's depositors stood at 306,400 in 1991. The growth of depositors appears to be in line with the growth of deposits with a

remarkable initial growth of 75 per cent in 1985 followed by a declining trend in later years reaching only 13 per cent in 1991.

Table 7.9 — BIMB: Structure of Depositors 1984-1991

Type of Deposit	Number of Depositors (as at 30 June)							
	1984	1985	1986	1987	1988	1989	1990	1991
Current	4,392	7,488	9,320	12,064	15,041	17,529	20,371	24,203
Savings	32,012	55,507	89,700	126,441	166,416	198,550	230,538	260,705
Investment	4,658	8,833	12,607	14,583	19,979	19,709	19,141	20,696
Other	0	77	85	99	105	206	325	798
Total	41,062	71,905	111,712	153,187	201,541	235,994	270,375	306,402
Type of Deposit	Percentage of Total(as at 30 June)							
	1984	1985	1986	1987	1988	1989	1990	1991
Current	10.7	10.4	8.3	7.9	7.5	7.4	7.5	7.9
Savings	78.0	77.2	80.3	82.5	82.5	84.1	85.3	85.1
Investment	11.3	12.3	11.3	9.5	9.9	8.4	6.8	6.8
Other	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: BIMB unpublished data 1984-1987, BIMB Annual Report 1988-1991

The depositors of the general investment accounts were mainly business enterprises and private individuals. It is evident that even though these accounts constituted the largest proportion of deposits, they have attracted fewer depositors. Because of the relatively smaller number of depositors relative to the large deposit base the average size of an investment account is estimated at M\$45000. This seems to imply that the Bank has a relatively high dependence on a small percentage of depositors for the main source of funds. For example, in 1989 close to 75 per cent of total deposits were placed by 9 per cent of total depositors. It is

therefore not surprising that withdrawals by a small percentage of these depositors will affect the growth of total deposits significantly.

In contrast to the investment accounts, the savings account drew the largest number of depositors but with small balances. About 32,000 savings accounts were opened during the first financial year but with deposits accounting for only 10.8 per cent of total deposits. The number of depositors for these accounts has increased steadily from 32,000 in 1984 to 260,000 in 1991; accounting for 85 per cent of total depositors (Table 7.9). The savings deposits were mainly mobilized from the general public of whom 90 per cent were Muslim individuals from the middle and lower income groups. The average credit balance of a savings account was estimated at about M\$959 as at 30 June 1991 although, it is suspected that there would be many accounts with smaller balances especially those belonging to the lower income depositors. The popularity of the savings account may be attributed to the bonus paid on these accounts and the fact that these accounts could be easily opened with a minimum deposit of M\$1.

Current account depositors accounted for 7 to 10 per cent of total depositors. The current accounts were less popular amongst individual depositors partly because these accounts do not yield any financial returns and also because several requirements such as an introducer and a minimum deposit of M\$500 have to be fulfilled before a current account can be opened.

Finally, the impact of Bank Islam in mobilizing deposits from the non-Muslims have been rather unsuccessful. As can be seen in Table 7.10, only one per cent of total depositors were non-Muslims at the end of 1989; whose deposits accounted for only 0.25 per cent of total deposits. It is apparent that more than 90 per cent

of depositors were Muslim individuals mostly with savings accounts as denoted by their small share of deposits. The largest proportion of deposits (72.25%) however is derived from the corporate sector which comprised about 5 per cent of total depositors.

Table 7.10 — Distribution of Depositors by Type as at 31 December 1989

Depositors	Number	%	Amount(\$'000)	%
Muslim Individual	236,975	94.63	314,927	27.50
Non-Muslim Individual	2,532	1.00	2,844	0.25
Corporate	10,922	4.37	827,719	72.25
Total	250,429	100	1,145,490	100

Source: Bank Islam Malaysia Berhad: unpublished data

In summary Bank Islam has played a significant role in the mobilization of deposits without interests. The rapid growth of its deposits in the first two years of operation show the important contribution of Bank Islam in the mobilization of savings and investments that otherwise would have been kept idle outside the banking system because of *riba*. The large proportion of deposits held in investment accounts is indicative of public confidence in the concept of profit-sharing as an alternative to interest. Nevertheless the susceptibility of these deposits to interest rate changes in recent years also suggests that the growth of deposits in future would most likely depend on the rate of return factor rather than the religious motivation.

7.3.4 Expansion of Branch Network

Another useful indicator of the performance of a commercial bank in deposit mobilization is its ability to mobilize deposits from as many potential depositors as possible through its branch network. In banking, branch expansion serves as a non-pricing method of attracting more deposits by bringing the bank to the people. For the Islamic bank the expansion of branches especially into the rural areas deserves special consideration since pious Muslims who are expected to form its largest clientele of loyal customers are mainly located in the rural areas. On the other hand, the setting-up of branches in the rural areas may not be cost-effective because of the greater uncertainties about the commercial feasibility of such a project and that the profit expectations in the initial years are generally not promising.²¹⁸

The dispersion of the Bank Islam branch network shows that the Bank had set up 29 branches throughout the country by the end of the 1991 financial year. The branching policy of the bank can be divided into two stages. The first stage which took four years to complete (1983-1987) has involved the establishment of at least one branch in all the fourteen state capitals. Thus by mid 1987 the Bank had opened eighteen branches of which fourteen were located in the 14 state capitals, three others in the city of Kuala Lumpur and another in Sungai Petani, a Muslim populated major town in the north-west of Peninsular Malaysia. The second stage of branch expansion began in 1988 following approval from the Central Bank earlier in 1986 which endorsed the Bank's plan to open eighteen more branch offices within a period of three to four years (Annual Report 1986:34). These branches were to be located in the secondary towns.

²¹⁸ Nienhaus 1988:13, Wilson 1990:24.

Table 7.11 — BIMB: Branch Distribution in Town Board or Local Authority Areas (Total Population \geq 10,000) as at 30 June 1991

Area Total Population \geq 10,000	Population Malay '000	Total '000	No. BIMB Branches	Area Total Population \geq 10,000	Population Malay	Total	No. BIMB Branches
1. Kuala Lumpur	305.4	919.6	4	18.Muar	25.5	65.2	1
2. Kuala Terengganu	166.3	180.3	1	19.Sibu	25.2	45.3	-
3. Kota Bharu	143.0	167.9	1	20.Miri	25.0	52.1	-
4. Johor Bahru	137.4	246.4	1	21.Pangkal Kalong	21.0	21.6	-
5. Kuantan	78.7	131.5	1	22.Butterworth	19.8	78.0	1
6. Taiping	55.5	146.0	-	23.Batu Pahat	19.2	64.7	1
7. Petaling Jaya	55.4	207.8	1	24.Sungai Petani	16.4	45.3	1
8. Kelang	51.7	192.1	1	25.Keluang	15.8	50.3	-
9. Ipoh	49.1	293.8	1	26.Melaka	15.4	87.5	1
10.Seremban	41.1	133.0	1	27.Port Dickson	13.4	24.4	-
11.Georgetown	40.7	248.2	-	28.Peringat	13.2	13.8	-
12.Sandakan	31.4	43.1	-	29.Teluk Intan	13.2	49.1	-
13.Kota Kinabalu	30.7	56.0	1	30.Shah Alam	12.6	19.0	1
14.Alor Setar	29.7	69.4	1	31.Pasir Mas	11.9	13.4	1
15.Tawau	26.8	43.2	-	32.Kemaman	11.9	16.0	1
16.Dungun	26.1	29.0	-	33.Kadok	11.6	11.7	-
17.Kuching	26.1	72.6	1	34.Lahad Datu	11.6	14.9	-

Source: Derived from Malaysia 1990-1991 Yearbook, Berita Publishing pp 78-79. There are 67 local authority areas having population \geq 10,000. Only 34 are shown in Table 7.11.

Based on the definition that areas having 10,000 or more population are defined as urban centres²¹⁹ the distribution of Bank Islam branches in Table 7.11 shows that the Bank has concentrated its branch network mainly to serve the urban Muslims. Twenty-three of the total 29 branches or 79.3 per cent of total branches as at 30 June 1991 were located not only in urban towns or local authority areas

²¹⁹ Fifth Malaysia Plan 1985:182

with population exceeding 10,000²²⁰ people but also in those with more than 10,000 Malay population. Four Bank Islam branches have been set up in the capital city Kuala Lumpur which had a total population of 919,400 in 1980 out of which 305,400 (33.2%) were Malays. Bank Islam branches have also been established in three other towns with high percentages of Malay/Muslim population namely Kuala Trengganu (85%) , Kota Bharu (92%) and Johore Bahru (85.6%). The rest of the branches were in selected towns generally with no less than 40 per cent Muslim population.

With the exception of six other areas²²¹ where the rest of the Bank Islam branches are located, Muslims living in the rural areas and even in urban areas having less than 10,000 Malay population are still not affected by the impact of Islamic banking as the bank branches have not yet reached these areas. A plausible explanation for this situation is that the Bank may have been constrained by the cost-effectiveness of setting full-service branches in these areas in view of the relatively small Malay/Muslim population or the low savings that could be mobilized. This may be deduced from the performance of existing branches in the poorer states, (that is, states with per capita GDP lower than the national per capita GDP) namely Trengganu, Kelantan, Kedah, Perlis and Pahang which registered low deposits compared to the large number of depositors.

For instance at the end of the 1990 financial year, the nine branches in these states accounted for 44.3 per cent of total depositors but with deposits which constituted only 23.7 per cent of total deposits (Table 7.12) which implies that higher operating costs may be involved to maintain these funds.

²²⁰ Based on the 1980 population census.

²²¹ Jertih, Kangar, Temerloh, Parit Buntar, Tampin and Bangi.

Table 7.12 — BIMB: Distribution of Depositors and Deposits in Lower Income States (as at 30 June 1990)

State	Number of Branches	Percentage of Total (%)	
		Depositors	Deposits
Trengganu	2	11.1	5.5
Kelantan	2	11.6	6.0
Kedah	2	10.7	7.7
Pahang 1	2	8.5	3.8
Perlis	1	2.4	0.7
Total	9	44.3	23.7

Source: Computed by the author from BIMB data on deposit position as at 30 June 1990.

Perhaps this may partly explain the latest plan of the Bank to set up mini-branches instead of full-service branches in so-called “strategic areas”.²²² As announced by Dr Abdul Halim, the Managing Director of Bank Islam, the establishment of a minibranch would incur M\$150,000 operating cost annually compared with M\$500,000 to run a full-service branch hence saving the Bank 30 per cent of operating cost if a minibranch is set up. The smaller cost involved will also imply that the minibranch will take a shorter time to breakeven.

The plan to set up mini-branches instead of full-service branches may be seen as an effort of the management of Bank Islam to balance between its social obligation of providing interest-free banking services to all Muslims and its objective to remain profitable. The plan offers a broader network of branches to serve the small savers and small borrowers in the rural and remoter areas whose dispersed locational character, low income and hence low savings do not justify the cost of setting up

²²² New Straits Times 18 January 1991.

full-service branches as in the urban areas.

It can be concluded therefore that Bank Islam has not reached the captive market of Muslims in the rural areas. The Bank has only grazed the tip of the iceberg in its deposit mobilization policy. Savers in the Malaysian rural areas are still not affected by the impact of Islamic banking since the current branch network has only reached the Muslims in the urban areas.

7.4 Application of Funds

Having examined the performance of Bank Islam in the mobilization of deposits, we now turn to the other side of the balance sheet and examine how the Bank has allocated its resources into earning assets by the various methods of Islamic financing and investments as described in Chapter VI. The main aim of this section is to examine (i) the growth of customer financing in order to gauge the extent to which customer deposits have been effectively utilized into credit and (ii) whether the business strategy of Bank Islam in the deployment of funds has been based purely on commercial grounds or has the Bank geared its financing operations towards the generation of socio-economic development as expected in theory.

At the outset the general performance of Bank Islam in the application of its funds can be gauged from the growth and structure of its total assets. This is because assets constitute the use of the bank's funds. Asset growth therefore constitutes an important indicator of business growth.

The asset structure of Bank Islam shows that the largest proportion of its earning assets during the 1984-1991 period was in the form of customer financing

(Tables 7.13 & 7.14). Except for three years (1984, 1987 and 1989) customer financing accounted for more than half of the Bank's total annual assets. On average the ratio of customer financing to total assets was estimated at 54 per cent annually. The highest ratio achieved was 62.6 per cent in 1985 while the minimum ratio was recorded at 46 per cent in 1987.

The next major item of the Bank's assets was the bank's investment in the Malaysian Government Investment Certificates (MGICs) and quoted and unquoted shares. On average, these investments accounted for about a quarter (27%) of total assets ranging from the lowest proportion of 13.9 per cent during the recession and the highest ratio of 38 per cent in 1988.

Together, customer financing and investments constituted between 72 per cent and 92 per cent of total assets over the 1984-91 period. The rest of the bank's assets were made up of cash and bank balances²²³, which constituted about 6% of total assets on average, and other assets such as investments in subsidiaries, amount due from subsidiaries, bills receivable, prepayments, intangibles and fixed assets which accounted for an average of 18 per cent of total assets during the first four years and 8 per cent between 1988-1991.

As Table 7.14 shows, the assets of Bank Islam stood at M\$325 million at the end of its first financial year in 1984 and rose four and a half times to M\$1357 million at the end of June 1991. This rise has been achieved at a relatively high annual average growth rate of 33 per cent in the 1980s. However, total assets grew at a marginal rate of 2 per cent in 1990 as a consequence of the decline in deposits and financing and contracted by almost 3 per cent in 1991.

²²³ These includes the statutory reserves with the Central Bank.

Table 7.13 — BIMB: Structure and Growth of Assets 1984-1991

Asset Type	Amount M\$ '000 (as at 30 June)							
	1984	1985	1986	1987	1988	1989	1990	1991
Cash & balances with banks	20.3	24.6	36.7	38.4	50.6	72.0	100.3	102.7
Customer Financing	161.1	322.0	395.3	428.6	609.4	666.1	807.8	789.3
Investment	73.2	71.7	135.7	315.4	432.5	507.8	379.1	337.3
Other Assets	70.9	95.9	115.1	149.9	41.6	122.4	109.0	127.9
Total	325.5	514.2	682.8	932.3	1134.1	1368.3	1396.2	1357.2
Total Asset Growth (%)	0.0	57.9	32.7	36.5	21.6	20.6	2.0	-2.8

Source:BIMB Annual Reports 1984-1991.

Table 7.14 — BIMB: Structure of Assets 1984-1991

Asset Type	Percentage of Total (as at 30 June)							
	1984	1985	1986	1987	1988	1989	1990	1991
Cash & balances with banks	6.2	4.8	5.4	4.1	4.5	5.3	7.2	7.6
Customer Financing	49.5	62.6	57.9	46.0	53.7	48.7	57.9	58.2
Investment	22.5	13.9	19.9	33.8	38.1	37.1	27.1	24.8
Other Assets	21.8	18.7	16.8	16.1	3.7	8.9	7.8	9.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Financing & Investment	72.0	76.5	77.8	79.8	91.8	85.8	85.0	83.0

Source:BIMB Annual Reports 1984-1991.

7.4.1 Customer Financing - Growth

In general, the growth of customer financing over the eight year period was largely dominated by two factors namely the growth of total deposits and the unfavourable loan climate during the recession; as characterized by the slow growths in the mid 1980s and modest growths in subsequent years (Figure 7.4). The rate of financing was, however, very high during the first two years of operations. The amount of credit rose by 99.8 per cent between 1984 and 1985 but the fastest growth was during the second half of the first financial year when the amount of financing increased four times from M\$407 million to M\$161 million. The increase in financing was much faster than the growth in deposits as indicated by the loan to deposit ratios which increased from 45 per cent at the end of 1983 to 78 per cent in 1985.

The rapid increase in financing operations during the first two years was largely attributed to the substantial increase in deposits which provided sufficient resources for the Bank to meet the demand for interest-free financing in the market. The most significant demand was from individuals seeking finance for the purchase of residential houses. Presumably these individuals had avoided taking housing loans from the government or the conventional bank previously because of *riba*. As at 31 December 1984, 35 per cent of total loans were extended to the property and construction sectors, of which 25 per cent were term loans to individuals for the purchase of residential houses. The relatively high percentage also reflects to some extent the confidence of the bank in approving such loans in view of the boom in the property sector in the early 1980s.

After a phenomenal start, the growth of financing slowed down considerably

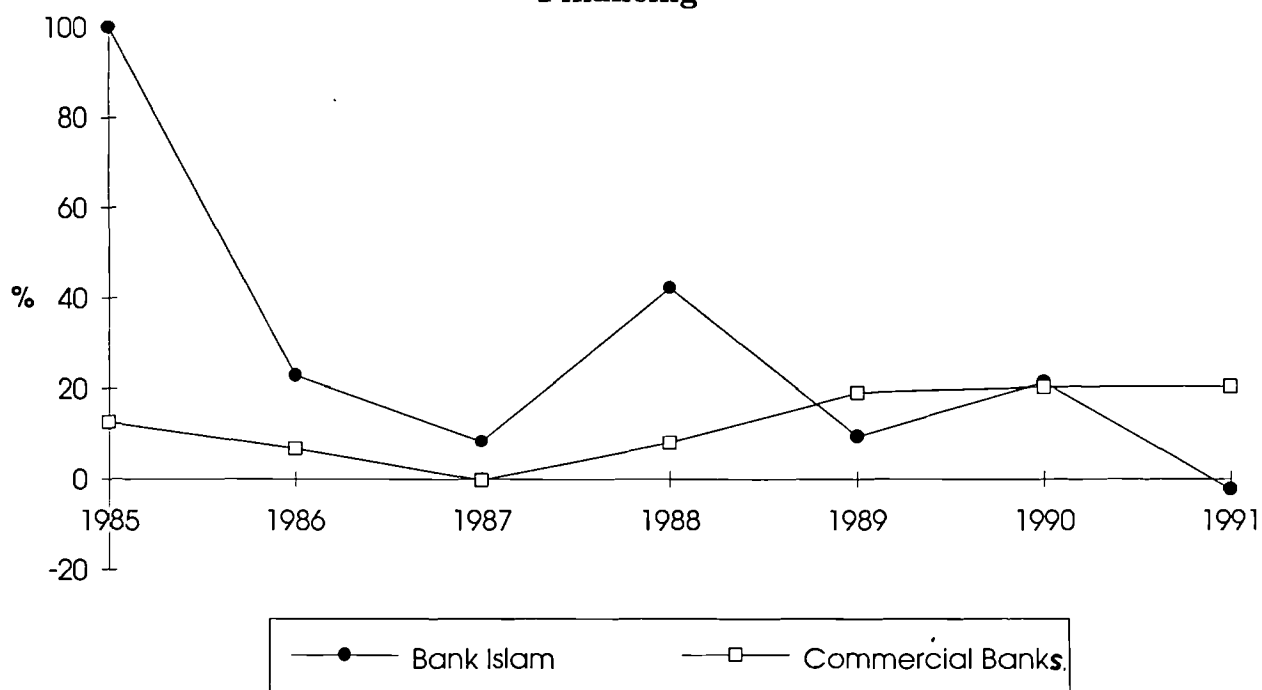
Table 7.15 — Customer Financing: Annual Growth 1984-1991

Year	Amount ¹ (M\$million)	Loan/Deposit Ratio(%)	Annual Growth (%)	
			Bank Islam ²	Commercial Banks ³
Dec 1983	40.7	45	0.0	24.0
1984	161.1	67	295.0	18.3
1985	321.9	78	99.8	12.6
1986	395.3	70	22.8	6.8
1987	428.6	53	8.4	-0.3
1988	609.3	60	42.2	8.1
1989	666.1	55	9.3	19.0
1990	807.8	66	21.3	20.3
1991	789.3	67	-2.3	20.4

Note: ¹ less provision for bad and doubtful debts, ² as at 30 June, ³ as at 31 December.

Source: Bank Islam Annual Reports, Bank Negara Annual Reports 1984-1991

Figure 7.4 — Bank Islam & Commercial Banks: Annual Growth of Financing



in the next two years. In 1986, financing grew at a rate of 22.8 per cent and only increased by 8.4 per cent in 1987. The slow-down in financing operations reflected the weak demand for loans throughout the banking system following the decline of economic activities as economic growth plunged into stagnation in the second half of 1985 and recovering only at 2 per cent in 1986. As can be seen in Table 7.15 the growth of commercial bank credit declined from 12.6 per cent in 1985 to 6.8 per cent in 1986 and was stationary in 1987. One of the major factors which further contributed to the sharp decline in 1986 was the collapse of property prices. The mounting of non-performing loans as a result of over-extending into the property sector and the series of runs in the banking system caused by the scandals of the deposit-taking cooperatives have forced commercial banks to be more cautious in approving new loans even though economic growth picked up by 5 per cent in 1987.

In the case of Bank Islam the shift towards a conservative financing policy was expressed by the Managing Director, Dr Abdul Halim²²⁴ in 1985 who stated;

The results of its operation during the first two years give us confidence as to its future.

The bank has laid down a fairly cautious plan for the next two years. The outlook is one of somewhat slow but steady growth, to be achieved with prudence and caution.

It is apparent that the change in policy was necessary for the Bank to adapt to the unfavourable economic climate to ensure a reasonable return to its depositors as well as its own survival. The Bank had earlier incurred a loss at the end of its first year of operations. Although the loss was considered normal, since new banks normally take at least three years to breakeven, it was reported that the loss was also caused by cases of bad debts on financing.²²⁵ Further failures may prove

²²⁴ 1985:13.

²²⁵ Shanmugam 1990:23, Malaysian Business June 1991:10.

disastrous not only to the bank but also to the Islamic banking philosophy.

To minimize the risk of loan default the bank has since adopted a 'committee system' whereby all financing applications must be approved by one of five financing committees depending on the amount of financing required. The system acts as a protection to ensure that all loans are double-checked before any decision is made. This is because the cost of non-performing loans is greater to Bank Islam compared to the other commercial banks since additional charges cannot be imposed on late repayments.

That the bank had been more prudent in its financing policy may be supported by the fact that its levels of provision for non-performing loans were lower than the industry average. As can be seen in Table 7.16, the amount of reserves put aside by the Bank to cover for bad and doubtful debts ranged between 1.0 and 3.4 per cent of total loans during the recessionary period. These were relatively lower than the industry figures which ranged between 3.8 and 7.6 per cent during the same period. (The industry figures are higher if interest-in-suspense is included.)

It is not known how much of Bank Islam's financing was non-performing during the period. However it is worth noting that total provisions for bad and doubtful financing constituted (i) specific provisions which covered specific accounts which have been reviewed and identified as bad and doubtful and (ii) a regular general provision to cover losses which were not specifically identified. Based on this information we can safely deduce that the percentage of non-performing loans or bad debts to gross loans were lower than the industry average in view of the fact that the Bank would have put aside more provisions if the incidence of such loans had been higher.

Table 7.16 — Provisions for Bad and Doubtful Debts, as a Percentage of Total Loans (1987-1990)

Financial Year	Provisions for Bad and Doubtful Debts	
Year	Bank Islam ¹	Commercial banks ²
1985	1.0	3.8
1986	1.7	5.7
1987	2.7	7.3
1988	3.4	7.6
1989	4.3	7.3
1990	4.2	6.1
1991	4.6	4.8

Note: ¹ calculated as a percentage of gross financing, ² excludes interest-in-suspense.

Source: Bank Islam Annual Reports & Bank Negara Annual Reports (1987-90)

Nevertheless, in spite of its prudent policy the quality of financing seems to have deteriorated in recent years. The ratio of bad and doubtful debt provision to total financing has been on an upward trend rising from 3.4 per cent in 1988 to 4.6 per cent in 1991 which is in contrast to the industry trend which seems to move in the opposite direction.

After two years of low growth the volume of financing rose significantly by 42.2 per cent in 1988. This was in line with the average growth of credit in the commercial banking system which also showed a marked increase of 8.1 per cent from minus three per cent the previous year. This general improvement in bank credit was mainly attributed to the improvement in economic activity as economic growth reached 8.9 per cent in 1988. Because economic growth after the recession was led by strong domestic demand, there was a substantial demand for credit from

the commercial and manufacturing sectors. As a result even though the property sector was still one of the leading sectors for loan growth in 1988, a larger share of credit of the banking system was extended to manufacturing and commerce rather than to the property sector. This was also true for Bank Islam. At the end of the 1988 financial year, almost 20 per cent of the bank's total financing were directed to the manufacturing sector compared to 12 per cent in 1987. For the first time since its establishment the Bank had diversified its credit away from the property sector. Nevertheless, priority was still given to housing loans especially for the purchase of medium and low-cost housing in line with the policy of the government to utilize the idle capacity in the construction sector. The growth of Bank Islam's financing rose by 21.3 per cent per year in 1990 which was close to the industry rate of 20.3 per cent. However the amount of credit extended contracted by 2.3 per cent in 1991 mainly because of the decline in total resources caused by the decline of total deposits for two consecutive years since 1990. Nevertheless, the decline in financing was slower than the decline in deposits as indicated by the loan-deposit ratio which increased by 1 per cent from the previous year.

In summary the growth of Bank Islam's financing activities was very much influenced by the prevailing economic conditions of the 1980s and the growth of total deposits. The rapid growth in financing during the first two years of the bank's operations was curtailed during the recession. Although there was modest growths afterwards, the expansion of financing activities in the early 1990s was constrained by the slower growth in deposits. However the injection of additional working capital following the Bank's flotation in January 1992 is expected to have provided a larger base for further asset expansion.

7.4.2 Financing Portfolio

The most striking feature of Bank Islam's financing portfolio during the period was the predominance of the so-called 'second-line techniques of financing' rather than the 'first line techniques' as recommended in theory.

As illustrated in Table 7.17, more than 90 per cent of total financing has been extended under the markup arrangements of *Bai Bithamin Ajil* (deferred sale), *murabahah* (cost-plus) and *ijarah* (leasing or hire-purchase). In fact since 1988, 99 per cent of total financing has been extended by one of these methods.

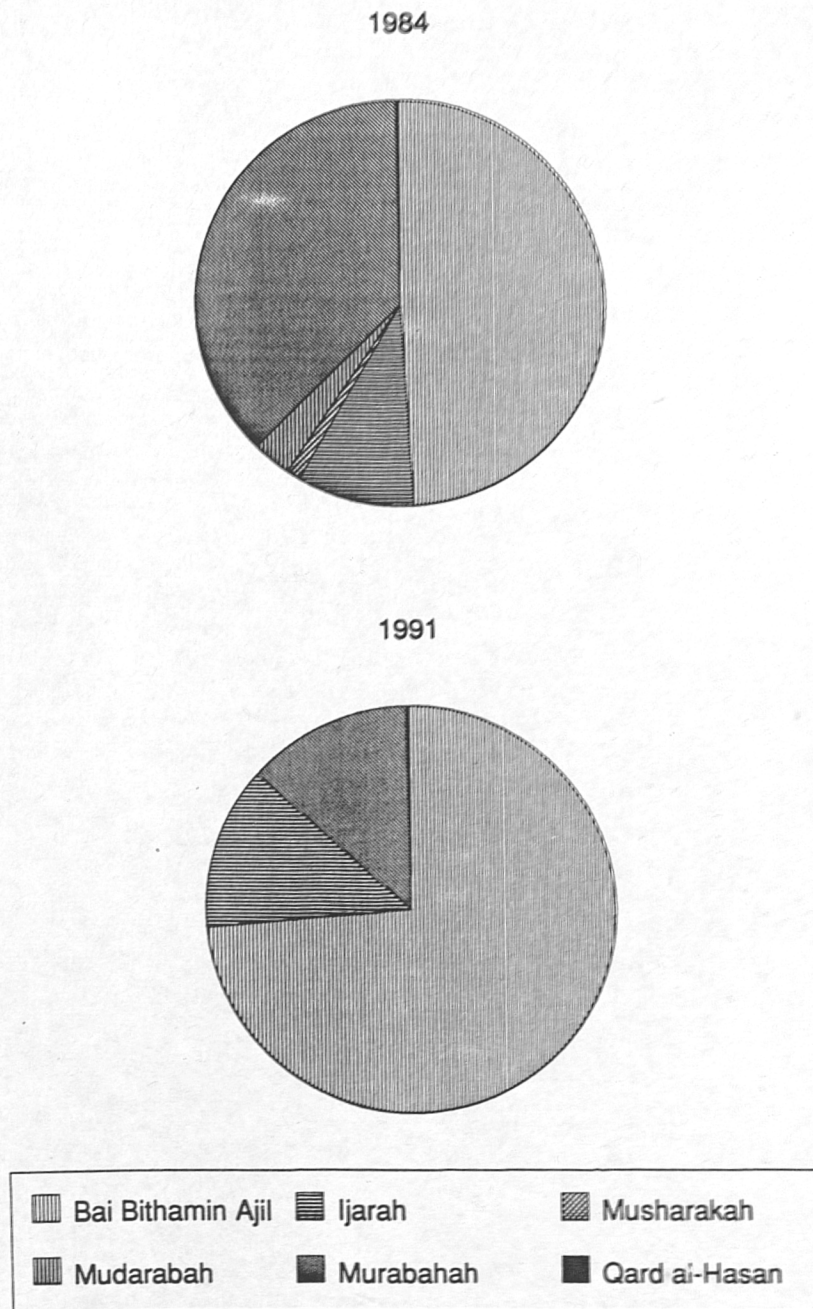
Table 7.17 — BIMB: Structure of Customer Financing 1984-1991

Type of Financing	Percentage of Total (as at 30 June)							
	1984	1985	1986	1987	1988	1989	1990	1991
Bai Bithamin Ajil	49.3	68.5	77.1	78.7	77.6	75.9	70.8	73.7
Ijarah	9.1	5.9	4.9	3.4	3.2	3.1	11.2	13.0
Murabahah	37.3	22.7	15.5	15.0	19.1	20.9	17.8	13.2
Subtotal	95.7	97.1	97.5	97.1	99.9	99.9	99.8	99.9
Musharakah	1.2	2.0	2.2	2.1	0.0	0.0	0.0	0.0
Mudarabah	3.0	0.9	0.3	0.3	0.1	0.1	0.1	0.0
Qard al-Hasan	0.1	0.0	0.0	0.5	0.0	0.0	0.1	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Derived from BIMB unpublished data 1984-1987, BIMB Annual Reports 1988-1991.

The most predominant was term loans under the deferred payment sale method of *Bai Bithamin Ajil*. Between 1984 and 1991, these deferred sale contracts accounted for the largest proportion of total financing. At the end of the first financial year, more than M\$80 million worth of financing have been extended under this

Figure 7.5 — BIMB: Structure of Financing 1984 & 1991



method which accounted for 49.3 per cent of total financing. By 1987 its relative importance has risen to 78.7 per cent declining marginally to 73.7 per cent of total financing in 1991. These contracts were mainly provided to finance the purchase of land, the purchase or construction of residential houses and the purchase of capital goods by large corporations. The duration of these loans usually exceeds one year to a maximum of twenty years.

A majority of financing extended under *Bai Bithamin Ajil* was small loans not exceeding M\$100,000 for the purchase of medium and low-cost residential houses by individuals. Since 1988, the Bank has devoted an increasing proportion of these small loans to finance the purchase of low-cost houses costing M\$25,000 or less.²²⁶

Bank Islam has also utilized the *Bai Bithamin Ajil* contract to syndicate large scale corporate financing. Its first attempt was to lead manage a M\$125 million deferred sale contract for the multinational Shell oil corporation to part finance the company's purchase of equipment for its local refinery. This facility was syndicated among ten participating financial institutions, each of which contributed funds in exchange for promissory notes, called *shahadah al-dayn* certificates, issued by the corporation. These debt certificates which mature in seven years can be securitized and traded in the capital market.

Because of its concentration on *Bai Bithamin Ajil* an average of 60 per cent of total financing extended by Bank Islam was for periods of over five years and only about 18 per cent was short-term loans which mature within a year (see Table 7.18). This structure distinguishes Bank Islam from the interest-based banks in Malaysia which have greater shares of loans in the short-term rather than in the medium or long term.

²²⁶ BIMB Annual Report 1988:33.

**Table 7.18 — BIMB, Hock Hua Bank & Domestic Commercial Banks:
Financing Maturities 1988-1990**

Repayment Period	Percentage of Total Gross Financing (as at 30 June)								
	BIMB			Hock Hua Bank			Domestic Industry		
	1988	1989	1990	1988	1989	1990	1988	1989	1990
Within 1 year	21	21	17	62	63	60	50	48	51
1-5 years	19	19	23	16	15	15	8	10	10
Over 5 years	60	60	60	23	23	23	41	42	39
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: BIMB Annual Reports 1988-1990, Hock Hua Bank Annual Reports 1988-1990, Malaysia: Economic Report 1992

Table 1.6.

In contrast to Bank Islam an average of 50 per cent of domestic commercial bank lending between 1988 and 1991 matured within a year and only 40 per cent of total loans were term loans for periods of over five years. A clearer pattern showing the predominance of short-term loans can be seen in the portfolio of the Hock Hua Bank whereby about 62 per cent of its loans matured within a year and less than a quarter were long-term loans of five years or longer.

The above difference between Bank Islam and the traditional commercial bank is primarily due to the difference between the accounting practice adopted by both systems. Unlike the interest-based commercial banks which tend to follow the "matching convention" by which short-term loans are mostly undertaken in view of the predominance of short-term deposits²²⁷, Bank Islam has adopted the "on-going concern convention" which permits it to organize all its customers' deposits into a single "pool of funds" from which it will undertake short, medium or long-

²²⁷ 90 per cent of deposits of Hock Hua Bank deposits for instance mature within a year.

term financing irrespective of the maturity periods of deposits placed by individual depositors. By this method on-going long-term financing can be financed by incoming deposits in place of the maturing ones. This method is adopted because around 60-70 per cent of Bank Islam deposits at any point in time constitute investment deposits which are short-term in nature and the distribution of profits on these deposits would be more realistic if it is based on cash profits generated from the Bank's on-going projects during the period the deposits are placed.

The small proportion of short-term financing provided by Bank Islam highlights the problem of providing Islamically legitimate short-term credit facility or 'overdrafts' by Islamic banks. Since these loans are often needed for consumption purposes and contingencies which cannot be based on the markup or profit-sharing arrangement Islamic banks are unable to resolve the basis on which these loans should be remunerated. Even though the extension of overdrafts on the basis of benevolent loans (*qard-al-hasan*) is permissible it is less suitable for the development of short-term credit facilities on a commercial and profitable basis. In some ways the absence of such a facility may have affected the competitiveness of Bank Islam in the market especially in attracting deposits from potential current account depositors who are accustomed to the overdraft facility provided by the interest-based banks.

The second most common form of financing extended by Bank Islam during the period was trade-financing on the principle of *murabahah* or mark-up sale. This constituted short-term financing in the form of letter of credit provided mainly to traders and wholesalers to facilitate the import and export of goods. Since this facility is self-liquidating it provides the Bank with a quick way of making profits with minimum risks. The proportion of trade financing ranged between

15 per cent and 37 per cent of total annual financing and its growth seemed to correspond closely to market conditions; with negative growth during the recession in 1986 and 1987 and a sharp rise by almost 65 per cent with the improvement in economic activities in 1988. It is interesting to note that the percentage of trade finance in the Bank's financing portfolio is below the average of other Islamic banks in the Middle-East. As noted earlier in Chapter III, more than 80 per cent of the financing operations of the Jordan Islamic Bank, Kuwait Finance House and the Islamic banks in Turkey were concentrated on short-term trade financing.

Nevertheless, it is envisaged that the share of trade financing in the Bank's portfolio is likely to be higher in the 1990s in view of the government policy of encouraging export-oriented industrialization. The introduction of two new Islamic financial instruments to facilitate trade financing; namely the Islamic Accepted Bills and the Islamic Export Credit Refinancing in 1991 indicates the Bank's foresight to expand its trade financing operations in future. According to Dr Halim, "any financial system has got to be ready to support a country's trade especially exports"²²⁸ In this respect Dr Halim sees the prospects of Bank Islam penetrating the Muslim market in trade financing. At present the Bank is the lead designated bank in the special bilateral payment scheme between the Central Bank and its counterparts in Iran and Pakistan.²²⁹

Hire-purchase agreement under *ijarah* was relatively undeveloped in the 1980s as shown by its share in the total which ranged between 3.1 to 9 per cent of total financing. However its importance in the Bank's financing portfolio has increased to 11.2 per cent and 13 per cent in 1990 and 1991. It was notable that the amount

²²⁸ New Horizon July 1992:16.

²²⁹ Under this arrangement each central bank guarantees international trade payment on behalf of its importers.

of financing under *ijarah* rose by 340 per cent in 1990 to M\$92.6 million from M\$21 million in 1989. This rise was mainly attributed to an *ijarah* financing facility worth M\$63.5 million extended to an oil refining company to finance the installation of equipment.

It is apparent from the preceding analysis that the structure of Bank Islam's financing portfolio reflects the corporate objective of the Bank; specifically "to operate as a commercial bank" which by its nature will be more inclined towards debt-financing rather than equity-financing. The Bank's deemphasis on equity-financing can be seen from the amount of financing allocated to both *mudarabah* and *musharakah*. The Bank seemed to have made some small attempts at equity-financing at the beginning by committing about 2 per cent and 1 per cent of total financing per year under *musharakah* and *mudarabah* respectively between 1984-1987. However since 1988 the ratio of both methods have become almost negligible in the Bank's financing portfolio.

It can therefore be deduced that, except for the absence of *riba*, the financing portfolio of Bank Islam does not differ significantly from the interest-based banks. The bulk of financing provided were still bound by the collateral and credit-worthiness criteria rather than project viability and profit-sharing. Nevertheless, whilst not concentrating on profit-sharing Bank Islam is 'superior' to the traditional interest-based banks to the extent that a majority of its loans are in the longer term and the cost of borrowing does not rise with the rise in interest-rates.

7.4.3 Sectoral Distribution of Finance

In terms of allocational performance, the basic criterion of evaluation would be the extent to which Bank Islam has directed its funds to finance activities or sectors which are deemed essential for economic growth or social equity.

As Table 7.19 shows the Bank has concentrated mainly in extending finance to the property sector throughout the past 8 years of its operation. However, lending to this sector was concentrated more on residential houses rather than commercial properties. More than 30 per cent of total financing were directed to the housing sector during the first three years of operation. As noted earlier, this high concentration was largely attributed to the high demand and the boom in the property sector. In addition it reflected the inability of the Bank as a new business concern to move beyond the trade-related means of financing.²³⁰ The percentage of finance to the property sector remained high accounting for an average of 25 per cent of total financing in the second half of the 1980s. This was mainly instigated by the Central Bank which encouraged all commercial banks to make strong commitments in providing more housing loans for the purchase of medium and low-cost houses as an anti-recession means to absorb the excess production capacity in industries producing materials for the construction sector. Excluding the housing sector, the share of financing directed to the construction and real estate sectors was relatively small in the initial years but has risen annually and was close to the industry ratio of 17 per cent in 1991.

The distribution of finance to the other sectors of the economy shows that the Bank has based its direction of lending in accordance with the relative importance of each sector in the Gross Domestic Product.

²³⁰ Mohd Yaacob 1986.

Table 7.19 — BIMB: Distribution of Financing By Major Sectors (%)
1984-1991

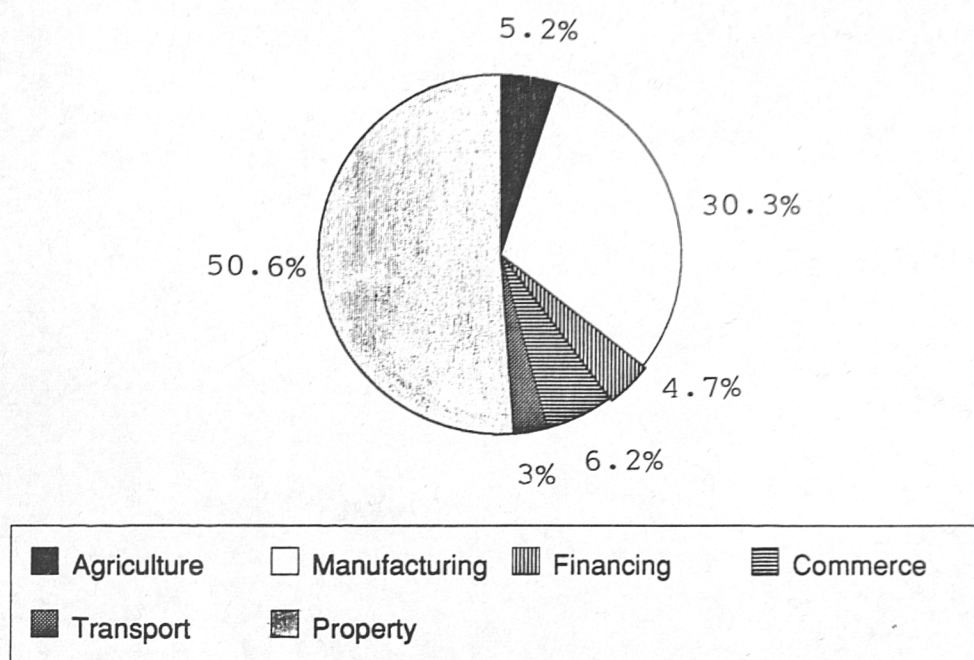
	Bank Islam								Commercial Banks	
Sector	1984	1985	1986	1987	1988	1989	1990	1991	1985	1991
Agriculture	0.5	3.3	2.4	3.7	5.2	5.2	5.3	5.2	5.9	4.8
Manufacturing	5.0	3.8	13.6	12.0	19.6	28.4	34.2	30.3	17.6	24.2
Services	29.6	32.8	21.0	38.1	21.2	15.4	13.1	13.9	31.4	27.1
Construction & Real Estate	1.4	2.9	5.8	16.7	26.9	25.9	20.6	18.1	21.8	17.0
Miscellaneous plus Housing	43.9	33.8	34.1	25.6	25.0	25.1	26.8	32.5	12.9	12.0*
Others	19.6	23.4	23.1	22.3	5.9	4.1	n.a	n.a	10.4	14.9

Note: * excludes housing loans sold to Cagamas.

Source: Bank Islam (unpublished data 1984-1986), Bank Islam Annual Reports 1987-1991, Bank Negara Annual Report 1985 & 1991.

Hence it can be observed that the smallest share of total financing was directed to the agricultural sector which accounted for 0.5 per cent of total financing in 1984 and has increased only to 5.2 per cent of total financing in 1991. Even though the share to total financing is comparable with the commercial banking industry average of 4.8 per cent in 1991, one would expect a larger commitment from Bank Islam since a majority of Muslims in Malaysia are engaged in agricultural activities. However this 'neglect' may be explained by the fact that the Bank is constrained by the distribution of its current branch network which is mainly concentrated in the urban areas. Secondly, the Bank is unable to compete with other development finance institutions and state agencies which are already serving this sector. The Agricultural Bank, for example, provides credit facilities to the small farmers and fishermen at a very low rate of interest of 4 per cent per annum as well as interest-free loans to the hard-core poor farmers to venture into viable agricultural projects.

Figure 7.6 — Distribution of Finance by Sectors 1991



Nevertheless there is still a market gap for Bank Islam in the agricultural sector especially among medium scale farmers and agricultural entrepreneurs who may not wish to use the services of other financial institutions because of *riba*.

In contrast to the agricultural sector, the proportion of total financing to the manufacturing sector has expanded significantly especially after the recession from 12 per cent in 1987 to 30.3 per cent in 1991. The diversification of lending into the manufacturing sector reflects the increasing importance of this sector as the

main engine of growth for the national economy, as discussed in Chapter IV. Apart from financing small manufacturing enterprises, Bank Islam has created a niche in syndicating large capital loans for corporations in the petroleum refining industry. Besides the *Bai Bithamin Ajil* financing facility for the Shell oil subsidiary company in 1990, the Bank has also lead-managed another M\$560 million in joint venture *musharakah* participation with the other financial institutions to raise capital for the same oil company. The other facility was an *ijarah* financing to another oil refining company in 1990 where the bank funded M\$63.5 million for the leasing of capital equipment to the company. It is expected that with the increase in its shareholders' funds after the flotation in 1992, the Bank will continue to expand its niche in providing large financing to the industrial sector. Whilst the ability of the Bank to become the sole funder for large corporate financing was previously limited by its small capital base; it is now able to compete in the market. With a bigger share capital of M\$133 million the Bank can expand into large scale financing within the 30 per cent (of shareholders' fund) credit limit as set by the Central Bank.

Based on the above facts and figures it does appear that Bank Islam has played a limited role towards the socio-economic development of the Muslim community, specifically in terms of exploiting the benefits that can be reaped from equity financing as envisaged in theory. Its loan portfolio has followed a pattern similar to that of the other interest-based banks in the country. Its niche appears to be among residential house buyers and industrialists. The former is an important contribution of the bank in promoting house-ownership especially amongst Muslims who hitherto have been constrained from taking housing loans either from the government or building societies because of *riba*. The fact that a high proportion

of these loans are small loans directed mainly to the middle and low income group proves that the Bank does cater to the needs of this group of clients. Nevertheless, the Muslims in Malaysia had generally expected Bank Islam to play a more enterprising role especially in providing finance to the newly-established Malay entrepreneurs. It was argued that the Bank could have made a greater contribution towards achieving the restructuring objective of the NEP had it resorted seriously to equity-financing rather than debt-financing.²³¹ Because of its concentration on the 'second-line techniques' the Bank has also been accused of being concerned only in making profits and neglecting the welfare elements in its operations.²³²

At the outset, the predominance of the 'second line techniques' in the financing portfolio of Bank Islam may be attributed to the Bank's effort to remain viable at the initial stage of development. On the one hand, the Bank has to ensure a reasonable rate of return to its depositors in order to encourage deposits. On the other, it has the responsibility of earning profits for its shareholders and also to be able to survive in the market. The uncertainty of profits and the lack of investment opportunities during the recession implied that there was a greater risk of loss associated with *mudarabah* and *musharakah* in such an adverse economic condition. As a consequence the Bank had to resort to the 'second line techniques' whereby expected profits could be predicted from the mark-up or profit-margin and that the risk of loss would be minimized by the collateral requirement. Project-financing, especially *mudarabah* is not easy to operate and requires experts or trained bank personnel in project evaluation and supervision which Bank Islam, as an infant bank lacks. Based on these impediments, it was envisaged that Bank Islam would have faced grave consequences had it ventured into *mudarabah* in a big way in the

²³¹ Ariff 1989:16

²³² Man 1988:91.

mid-1980s.²³³

Apart from the above constraints, another important and fundamental factor that has resulted in the lack of equity-financing is the negative attitude of the present management towards the theory of Islamic banking as advocated by the writers on Islamic banking. Basically, the present management does not accept the theory that Islamic banking should be organized solely on the basis of *mudarabah* and *musharakah*. According to Dr Abdul Halim,²³⁴ the theory which implicitly rejects the application of the markup and the profit margin contracts lacks the basis of the *Shariah* and contradicts the *Quranic* injunctions which permitted trade as an alternative to *riba*. He points out that the so-called 'second line techniques' of financing are contracts of exchange based on the principle of trade which are not only legitimate but also encouraged in the *Quran*. On the other hand, the legitimacy of the two-tier *mudarabah* is dubious, since not all *madhab* (schools) accept the view that a bank which acts as the *mudarib* can enter into a second round of *mudarabah* transaction with the entrepreneur-borrower. Dr Abdul Halim also believes that an Islamic commercial bank has no direct responsibility in promoting socio-economic development. This view is based on the argument that the place of the Islamic commercial bank is in the business or *tijari* sector with the prime objective of making profits. Nevertheless its contribution to the development process is in the form of *zakat* that it pays from the accrued profits. Socio-economic development, on the other hand, lies directly in the hands of the State and enforced by state-agencies and specialized financial institutions.

The preceding arguments imply that the financing portfolio of Bank Islam is

²³³ Ariff 1989:30.

²³⁴ 1989.

likely to remain concentrated on the 'second line techniques' in the near future. Unless there is a change in the attitude of the management it would seem unlikely that the Bank will direct its customers' deposits mainly into the profit-sharing type of financing as conceived in theory. As emphasized by Dr. Abdul Halim as a commercial bank which provides a variety of banking and financial services Bank Islam will provide both debt-financing and equity financing. The immediate strategy of the Bank in equity financing is to develop a venture capital subsidiary that will raise capital in the secondary market through *musharakah*.

In summary the financing portfolio of Bank Islam has mainly been geared towards the provision of interest-free finance to the extent that *riba* is not involved in any of its transactions. This refers to the predominance of trade or sale related financing where the Bank earns its profits by charging a markup. Equity-participation has only been confined to large corporations to minimize the risks of loss. Finance to the lower income group has been concentrated in soft areas of finance mainly housing which reflects a high degree of risk aversion and conservatism on the part of the Bank at the expense of exploiting the potentials of higher profits. Even though the Bank has managed to report profits since the second year of its operation, the rates of returns on investment account deposits have been relatively low, ranging from 5 per cent to 7.5 per cent over the period. The dividends paid to shareholders were also marginal ranging from 2 per cent to 5 per cent between 1988 and 1991.

Nevertheless, it cannot be denied that Bank Islam has been successful in the disbursement of its funds to deficit units for profits without endangering its viability and survival in the process of growth as stated in its corporate objective.

7.5 Financial Performance

7.5.1 Revenue, Income and Profitability

Notwithstanding its social obligations to the development process, the ultimate test for Bank Islam, as a financial intermediary, lies in the ability of its management to generate income and profits that will ensure its existence in the market.

The Bank made its first profit in the second year of its operation in 1985 and has remained profitable since then (Table 7.20). Pre-tax profits were relatively low during the recession with the lowest profit of M\$3.7 million in 1986. However, as the economy recovered and the amount of deposits and financing expanded, profits before tax grew strongly between 1987 and 1990 with a record growth of almost 60 per cent per annum in 1989. Nevertheless, the growth of pre-tax profits has moderated in recent years rising only by 35.4 per cent in 1990 and marginally by 3.4 per cent in 1991. The small rise in pre-tax profits was consistent with the decline in the growth of income as a consequence of the fall in deposits and the volume of financing.

The ability of the Bank to remain profitable reflects the higher amount of income and revenue over its expenditure. The operating revenue of the bank which constitutes income derived from its pool of depositors' and shareholders' funds stood at M\$97.7 million in 1991 compared to M\$36 million in 1985. About 90 per cent of the Bank's operating revenue is derived from its depositors' funds; which consists primarily of income from financing and investment in the MGICs. Income from the shareholders' funds, on the other hand, which is made up mainly of income from fee-based services as well as investments in the MGICs constitutes only 10 per cent of total revenue. The large share of income derived from the depositors' funds

**Table 7.20 — Bank Islam Group: Revenue, Income and Profits
1984-1991**

	1984	1985	1986	1987	1988	1989	1990	1991
Income from:								
Depositors' Fund	n.a	n.a	n.a	n.a	64.3	80.9	81.3	84.2
Shareholders' funds	n.a	n.a	n.a	n.a	7.0	7.9	10.4	13.5
Operating Revenue	n.a	36.1	50.1	62.6	71.3	88.3	91.7	97.7
Less:								
1.Profits to Depositors	n.a	17.7	26.6	32.7	34.7	45.4	45.1	49.5
Income	n.a	18.4	23.5	29.9	36.6	43.4	46.6	48.2
Expenditure	n.a	n.a	n.a	n.a	30.4	33.5	33.2	34.1
Pre-Tax Profits	-1.3	4.4	3.7	4.5	6.2	9.9	13.4	14.1
Profit After Tax	-1.8	2.6	2.2	0.9	2.9	5.2	6.9	8.4
Annual Growth	(%)							
Operating Revenue	n.a	5.4	38.9	24.8	13.6	24.9	3.3	6.8
Income	n.a	n.a	27.7	27.3	22.4	18.6	7.4	3.4
Expenditure	n.a	n.a	n.a	n.a	n.a	10.2	-0.9	2.7
Pre-Tax Profits	n.a	138	-15.9	21.6	37.7	59.7	35.4	3.4
2.Profit to shareholders	n.a	n.a	n.a	n.a	29.6	35.5	36.2	34.7
Profitsharing Ratio 1:2					54:46	56:44	55:45	59:41

Note: n.a - not available

Source: BIMB Annual Report 1984-1991

provides evidence of the Bank's reliance on financing and investment rather than on fee-based banking services. Because of its greater contribution, the depositors' fund has been attributed a greater profit-sharing ratio relative to the shareholders' fund. In 1991, the ratio was 59:41 in favour of the depositors.

The growth of Bank Islam's expenditure has been relatively modest rising at a rate of 10.2 per cent in 1989 and 2.7 per cent in 1991. The decline in the growth of expenditure in 1990 and 1991 was mainly attributed to the decline in the amount of provision for bad and doubtful debts. It was observed that whilst the cost of other expenditure items increased during the three year period the amount of provision for bad and doubtful debt fell from M\$8.8 million in 1989 to M\$5.5 million in 1990 and further down to M\$3.5 million in 1991. On the other hand, personnel costs which constituted the largest portion of expenditure has continued to expand from 41 per cent of total expenditure in 1990 to 46 per cent in 1991 in line with the recruitment of new staff as the bank established two to three new branches every year.

7.5.2 Return on Assets and Equity

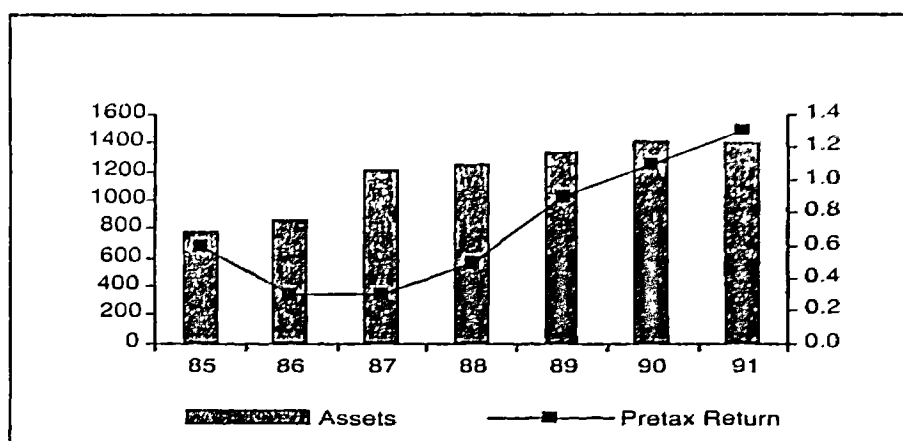
Even though the growth of its pre-tax profits has moderated since 1990, the pre-tax return on assets (ROA)²³⁵, as denoted by the ratio between net-profit before tax and average total assets, has improved tremendously over the past few years rising from 0.4 per cent in 1988 to 1.3 per cent in 1991. (Figure 7.7)

Since the pre-tax return on assets ratio measures the capability of the management in generating profits from its assets, the overall increase in the profitability reflects the expansion in the financing and fee-based activities over the period. The

²³⁵ This is calculated in terms of Bank Islam as a Group which includes its subsidiaries.

overall increase in profitability reflects the expansion in the volume of financing and increased fee-based activities over the period.

Figure 7.7 — BIMB: Asset Growth & Return on Asset



Source: BIMB: Public Listing Prospectus 1991

The profitability of Bank Islam has also improved from the shareholders' point of view. The after-tax return on equity (ROE), as represented by the ratio of the Bank's profit after tax to its average shareholders fund, has risen every year except in 1987 when net profit before tax was very low at M\$0.9 million compared to the average shareholders' funds of M\$83.3 million. In 1988 the ROE ratio (at the Bank level) was 3.5 per cent compared to 0.01 the previous year. By 1991 it has risen to 8.7 per cent.

The relatively high return on equity in 1988, was reflected in the Bank's decision to pay a maiden dividend of 2 per cent to its shareholders that year. The dividend payout has increased by one percentage point annually but has remained lower than the profits pay-out on investment account deposits. This may be explained by the fact that total deposits represented a higher proportion of total liabilities which implies a higher risk on the part of the depositors. Nevertheless, the margin between dividend and profit pay-outs has been closing up every year from 2.6 per cent in 1988 to 0.6 per cent in 1991 which reflects the expansion of share capital and the decline in deposits. As can be seen in Table 7.21 total deposits stood at 13.7 times to total equity in 1989 but has declined to 11.8 times in 1991.

Table 7.21 — BIMB: Return on Equity, Dividend, Deposit to Shareholders' Fund

(As at 30th June)	1987	1988	1989	1990	1991
Return on Equity	1.1	3.5	5.9	7.6	8.7
Dividend	0.0	2.0	3.0	4.0	5.0
Deposit to Shareholders' funds(times)	9.9	11.9	13.7	13.2	11.8
Deposit to Total liabilities (%)	86.8	88.6	89.8	87.4	86.6

Source: BIMB Annual Report 1984-1991

Interbank comparisons shows that Bank Islam has a competitive position among the other interest-based banks of similar size. As evident in Table 7.22, its pre-tax return on assets (ROA) for the 1990 financial year is higher than that of the Oriental and Ban Hin Lee banks. The return on equity (ROE) ratios also show that Bank Islam had the highest return on equity among the peer group. Its

return on equity ratio was 15.6 per cent in 1990 which was higher than the ratios for the other banks. This implies that Bank Islam has provided a more attractive return on investment to its shareholders.

Table 7.22 — Pre-tax Rates of Return (%)

Bank	Return on Asset (ROA)	Return on Equity (ROE)
Bank Islam(FY 1991)	1.3	18.0
Bank Islam(FY 1990)	1.1	15.6
Hock Hua (FY 1990)	1.7	11.4
Ban Hin Lee(FY 1990)	0.8	8.4
Pacific (FY 1990)	1.2	12.0
Oriental (FY 1990)	0.6	11.0

Source:BIMB: Public Listing Prospectus 1991

7.5.3 Liquidity

One of the serious problems faced by Bank Islam in maintaining the trade-off between risk and return on its assets is the persistent problem of excess liquidity. Essentially, the Bank is required to comply to a primary liquidity requirement of 10 per cent of its current and savings deposits and 5 per cent of its investment deposits. However, the liquidity ratio of Bank Islam has always exceeded the above requirements. The average primary liquidity ratio,²³⁶ was 12.9 per cent between 1988 and 1991 with the highest ratio of 15 per cent in 1989 (Table 7.23). Its secondary liquidity ratios²³⁷ has far exceeded the 5 per cent minimum requirement.

²³⁶ This is expressed as the ratio between cash and balances plus MGICs pledged for interbank settlement over the sum of current and savings deposits.

²³⁷ This is represented by the ratio of the sum of cash plus MGICs to investment deposits

Between 1987 and 1989, an average of 56 per cent of total investment deposits were held in liquid assets mainly in the form of MGICs. The highest ratio in 1988, reflects the rise in the Bank's investment in the MGICs which rose by 38 per cent from 1987. The problem of excess liquidity is unique to Islamic banks primarily because of the lack of Islamically accepted short-term investments in the secondary market. As shown in Table 7.22 even though the interest-based banks also suffer from excess liquidity²³⁸ their rates are lower than that of Bank Islam because of the availability of relatively more short-term investments in the money market ranging from overnight loans to government securities.

Table 7.23 — Liquidity Ratios 1987-1991

Bank	Liquidity Ratios (%)				
	1987	1988	1989	1990	1991
Bank Islam					
Primary Ratio	n.a	13.9	15.0	11.2	11.6
Secondary Ratio	53.7	59.8	55.2	45.9	43.6
Ban Hin Lee	18.9	29.6	43.9	29.1	n.a
Hock Hua	n.a	27.5	38.4	28.5	n.a

Source: BIMB: Annual Reports 1987-1991, Ban Hin Lee Annual Reports & Hock Hua Annual Reports relevant years.

For Bank Islam the problem of excess liquidity is partially mitigated by the issue of the MGICs by the Central Bank. In the 1980s, more than 90 per cent of the Bank's liquid assets were held in the MGICs. One of the recent attempts by Bank Islam to reduce its concentration on the MGICs is the issue of the *shahadah*

²³⁸ The liquidity ratio for the interest-based commercial banks is set at 17 per cent of total deposits.

al-dayn debt certificates in 1990. The medium term nature of these certificates provide higher profitability than the MGICs whilst still provide liquidity to the Bank through securitization in the capital market. A sharp decline can be noticed in the secondary liquidity ratio in 1990 and 1991 as the Bank reduced its investments in the MGICs following the introduction of the *shahadah ad-dayn* debt certificates.

7.6 Conclusion

From the preceding analysis we can conclude that Bank Islam has proved to be a viable financial institution for the mobilization of interest-free deposits based on the principle of profit-sharing.

Our analysis of Bank data has shown that the religious factor rather than the economic factor was more closely associated to deposit growth in the first two years of operations. Based on this observation and looking at the high growth of deposits and the number of depositors during that period it can be deduced that Bank Islam has fulfilled a developmental role of mobilizing savings and investment that conventional banks have previously failed to attract. Nevertheless, the bank has experienced significant withdrawals of investment deposits in recent years following the rapid rise in interest-rates on fixed deposits. This implies that the future growth of deposits will depend on the ability of Bank Islam to offer competitive rates of return. It should also consider expanding its branches into the rural areas where a captive market is presumably ready to be exploited.

On the asset side, the performance of Bank Islam has been constrained by the recession in the mid-1980s and the decline in deposits in recent years. In view of the 'hostile environment' the Bank has adopted a policy of prudence by concentrating on trade-related methods of financing and soft areas of finance.

Because of the deemphasis on equity participation and profit-sharing methods of financing the performance of Bank Islam has fallen below public expectations on its developmental role.

Nevertheless Bank Islam has proved its commercial viability and profitability which is a good signal for a competitive market in Islamic banking after the end of the Bank's 10 year monopoly in 1993.

Chapter VIII

A Survey Of The Market: Methodology And Fieldwork

8.1 Introduction

Having examined the functional and financial performance of Bank Islam based on the facts and figures obtained from secondary sources published by Bank Islam, the Central Bank and other official publications it is pertinent to extend this study to the other side of the counter specifically to explore the banking behaviour and perceptions of the depositors and the non-depositors of Bank Islam. The main objective of this study is to find out the bank selection criteria of Muslims who bank at Bank Islam on the one hand and Muslims who are not the depositors of Bank Islam on the other; and consequently examine their implications for the marketing of Islamic banking services to a bigger segment of the Malaysian population.

The significance of Muslim individuals as the target market for Islamic banking in Malaysia cannot be underestimated. Their continuous support is essential to ensure the survival of an institution which has been specially set up to meet their religious obligations. The stagnation of Bank Islam's total deposits in 1990 and 1991 is an indication that Islamic banks cannot depend entirely on the corporate sector for deposits when interest rates are rising. It is envisaged that the rate of interest does not matter to a majority of Muslim individuals. Yet many still do not patronize Bank Islam due to other factors which have denied the Bank of its potential market share.

In broad terms, the Muslim market can be divided into three segments: the strict or pious Muslims who totally avoid the *riba* banks, the less strict Muslims who hold accounts both at Bank Islam and the interest-based banks; and the least strict Muslims who have accounts only at conventional banks. The banking behaviour of these groups are expected to differ from each other and an understanding of these differences may provide some useful implications on how the Islamic banking services should be marketed to meet the banking needs of each group. There is a set of questions to be addressed in this study; for example: What factors have attracted depositors to Bank Islam?; why do other Muslims prefer the conventional banks?; how would depositors respond if interest-based banks were allowed to open Islamic counters?; were depositors aware of the different methods of Islamic financing available at Bank Islam?; what kind of bank services are needed?; and are these services available at Bank Islam?

This chapter provides the research methodology of this market study. Section 2 introduces the research design. Section 3 outlines the objectives and hypotheses. Section 4 discusses the development and administration of the field work while the methods of statistical analyses are presented in Section 5.

8.2 The Research Design

A research design is simply the framework or plan for a study used as a guide in the collection and analysis of data. Its purpose is to ensure that the study will be relevant to the problem being investigated and that economical procedures will be undertaken. The choice of a research design therefore depends greatly upon the nature of the study and the amount of resources available.

There are many types of research design and many ways of classifying them.

According to Sellitz *et al* (1976), research can take the form of three basic designs—either exploratory, descriptive or causal—depending on the fundamental objective of the research. Churchill (1983) further explains that the objective of exploratory research is to gain insight and ideas, to establish priorities for further research and to clarify concepts. Descriptive research, on the other hand, is typically concerned with determining the characteristics of certain groups or of testing the relationships between two variables. Causal or explanatory research takes the form of experiments and is concerned with identifying cause-and-effect relationship. Taken as a whole these three basic designs can be treated as different stages in a continuous process of study which generally begins with exploratory research as the initial step followed by descriptive and eventually causal research.

Based on the above classification and the limited resources available to the researcher, this study is best described as exploratory and descriptive because it involves initial steps such as the identification of factors, describing the characteristics of Bank Islam depositors and non-depositors and testing the existence of relationships. The main objective of choosing such an approach is to prepare the ground for future experimental research where cause -and-effect relationship can be investigated.

8.3 Research Objectives and Hypotheses

There are two main objectives of this study.

1. To examine the banking behaviour of the different categories of Bank Islam customers and determine the factors that have influenced them to bank at Bank Islam.

2. To examine the perception of the Muslim non-depositors of Bank Islam, to find out why the conventional banks were more preferred and to identify the main reasons which had discouraged this group from opening accounts at Bank Islam.

8.3.1 Hypotheses - Depositors of Bank Islam

It may be expected that the interest-free nature of Bank Islam gives the bank a competitive edge over its interest-based counterparts in deposit mobilization among Muslims. It is also envisaged that since the market is predominantly Muslim the bank can depend on the religious motivation to attract customers. The examination of Bank Islam performance in Chapter VII, however indicates that the role of the religious factor may have been overemphasized. Whilst the religious motivation may have been effective during the initial years as shown by the rapid growth of deposits and depositors the relatively slower growth of both variables in recent years could imply the interplay of other factors. The secondary data has also shown that institutional customers have withdrawn their deposits from Bank Islam when interest rates on conventional bank deposits rose in 1990. This study will attempt to find out if individuals would also respond in the same manner.

Earlier researchers on Bank Islam have drawn several hypotheses about the customers of Bank Islam. Man (1986:52) has made the following conjectures;

1. 'some depositors come to the bank because they fully accept the Islamic principles regardless of the rate of profits.'
2. 'quite a large number of them will continue to be customers only if the bank can maintain a reasonable rate of profit.'

3. 'the majority of depositors still maintain contacts with conventional banks, at least by holding current account deposits.'

In another study, Mohd Yaacob (1986:112) envisaged that,

1. 'pious Muslims virtually provide the captive market for the Islamic bank....(and are)....expected to prefer the Islamic bank over the conventional banks in placing their funds.'
2. 'the majority of Bank Islam depositors are new depositors who have had no accounts in conventional banks before.'
3. 'the non-Muslims and less pious Muslims form the non-captive open market source of funds and this group of savers is likely to respond differently to differences between the rates of returns offered by the Islamic bank and the conventional bank. '

Both studies seem to indicate that at least two categories of Bank Islam depositors can be identified namely (a) those who bank exclusively at Bank Islam and (b) those who bank at Bank Islam and yet hold other accounts in the conventional bank. As seen earlier, Man (1986) envisaged that many of Bank Islam depositors would belong to the latter category. As stated by Man 'the majority of depositors still maintain contacts with conventional banks ...'.

Mohd Yaacob (1986:216) notes that a majority of Bank Islam depositors would be newcomers into the banking system hence bringing into the Islamic bank new deposits which could not be mobilized by the interest-based banks before. It is envisaged that this hypothesis is more relevant to Islamic banks in the rural economies where the religious motivation to avoid *riba* is still high. This is based

on the findings by Ungku Aziz (as described in Chapter VI) which show that a sizeable portion of savings in the rural areas were kept out of the banking system because of lack of *halal* outlets.

The subject of interest in this study, however, is not the rural Muslim but the urban Muslim. This is based on the fact that, in general, only the latter has been exposed to Islamic banking in Malaysia. As we have seen in Chapter VII the branches of Bank Islam are concentrated mainly in the urban areas. Moreover, whilst depositors in the rural areas may be considered as the loyal depositors of Bank Islam, it is the urban Muslims (with their different levels of piety) who pose the real test for the viability of Islamic banking in the competitive urban environment.

Our main hypotheses are:-

- (i) The Islamic bank depositors in the urban areas have developed the financial habit of institutionalizing their savings even before the establishment of the Islamic bank. It is expected that hoarding was not customary in the urban areas and that a majority of depositors, even those who now bank exclusively with Bank Islam had held accounts in the interest-based banks previously.
- (ii) The establishment of Islamic banking in the urban areas has mainly effected a transfer of resources within the market by attracting funds that might have been placed in the interest-based banks; with little impact on mobilizing new deposits which the interest-based banks had failed to attract.
- (iii) A majority of depositors are likely to hold accounts in both the Islamic and *riba* banks for the purpose of convenience.

- (iv) Depositors who bank exclusively with Bank Islam are more committed in avoiding *riba* and hence form the loyal depositors of the Islamic bank.
- (v) The religious motivation, rather than convenience or social influence is the main reason why depositors choose Bank Islam as their primary bank.
- (vi) Depositors who do not bank exclusively with Bank Islam are more likely to forgo Islamic banking for the sake of convenience.
- (vii) Depositors who bank exclusively with Bank Islam are not likely to agree with the establishment of Islamic counters at the conventional banks.

8.3.2 Hypotheses: Muslim depositors of Riba banks

The third group of Muslims who form the potential market for Islamic banking in Malaysia are Muslims who hold bank accounts only in the conventional banks. To the best of the researcher's knowledge no research on the Malaysian financial market has been devoted to investigate the bank selection behaviour of the Muslims or Malay depositors of the conventional banks. Nevertheless, it is envisaged that the bank selection criteria for these depositors would not differ much from the typical conventional bank depositor.

Several studies conducted separately in the United States have shown that depositors are mainly motivated by 'convenience' in their bank selection decisions. Kaufman (1969) reported that convenience and the quality of services were considered most important by customers in selecting a primary bank. It is noted that the term 'convenience' has many connotations to consumers and hence different aspects of convenience need to be considered. These would include locational convenience, transportation facilities and transactional convenience. A study by

Bowers (1969) showed that fifty-eight per cent of the population sample surveyed rated convenience to home and work as the most important determinant of their bank choice. Other factors have also emerged in more recent studies. For example Anderson, Cox and Fulcher (1976) found that 'recommendation by friends' was ranked more influential than 'locational convenience'. This finding is supported by another study (Tan 1981) carried out in Singapore which reported that consumers tend to follow the advice of friends, neighbours and family hence giving less importance to convenience when selecting a bank. Chua (1989) also found that Malaysian depositors tend to attach high importance on the financial services (which include the rates of interest on deposits and loans) besides convenience and social influence.

Whether the bank selection behaviour of Muslims who bank entirely with the *riba* banks are similar with that of the typical conventional bank customer will be investigated.

On the assumption that Muslims who bank with the interest-based banks are less committed in avoiding *riba* the following hypotheses will be tested.

- (i) Muslims who bank with the interest-based banks do not perceive that interest is the same as *riba*.
- (ii) These Muslims are motivated to bank primarily with the conventional banks because of convenience.
- (iii) These Muslims are not motivated to bank with the Islamic bank because of the lack of convenience.

8.4 Fieldwork: Methodology and Administration

Since this study is exploratory in nature the sample survey would be the most appropriate method of data collection. By this method, data is collected only from a portion of the population from which appropriate inferences about the population can be made. Even though this would mean that the sample serves only as an approximation of the entire population it has been recommended as highly accurate if done with care²³⁹.

To ensure that findings based on the sample survey is a reasonably accurate representation of the population, it is necessary that the sample is selected in such a way that findings based on it are likely to correspond closely to those that would be obtained if the whole population were studied²⁴⁰. Obviously a sample which represents the population perfectly can rarely be created but the chances of forming a representative sample can be considerably enhanced if certain requirements and procedures are followed.

A good sample is one which is free from bias and error in the selection process. According to Yates²⁴¹ bias may arise because of the following reasons;

1. The 'representative' sample is deliberately selected
2. Failure to cover the whole of the chosen sample (as a result of unreturned postal questionnaires for instance) and
3. Substitution of another convenient member of the population when the chosen unit is not available.

²³⁹ Bailey 1987: 83

²⁴⁰ Sellitz op.cit:73

²⁴¹ 1971:9

It is universally agreed that the simplest and perhaps the only way to avoid these causes of bias is to draw the sample either entirely at random or at random subject to restrictions which are necessary to improve accuracy but do not introduce bias into the results.²⁴² Random or probability sampling does not, however, mean haphazard sampling. A random sample can only be obtained by following some proper probability process such as the drawing of lots or using a table of random numbers. De Vaus²⁴³ asserts that because the characteristics of most randomly selected samples will be close to those of the population, the probability theory can be used to help make inferences about the true population.

Sampling error, on the other hand, refers to differences between the sample and the population which arise because of improper sampling.²⁴⁴ Such error depends on two main factors²⁴⁵:-

(a) The variability of the key characteristic under study.

The more varied the population with respect to the relevant characteristic, the larger the potential sampling error will be. One way to reduce this kind of sampling error is to stratify the population into blocks so that the units in each block or stratum are as homogeneous as possible. Each strata is then sampled at random according to definite proportions so that each stratum will be represented in these proportions in the sample.

(b) The size of the selected sample.

The larger the sample the smaller will be the sampling error. According to

²⁴² Yates 1971, Bryman 1990

²⁴³ 1990:53

²⁴⁴ Bryman op.cit:103

²⁴⁵ De Vaus op. cit, Yates op cit:17

Yates, other things being equal, the random sampling error is approximately inversely proportional to the square root of the number of units included in the sample. Thus a sample size of 100 gives a sampling error of 10%, a sample of 400 has a sampling error of 5% and if the sample is increased to 1,000 cases the sampling error will fall to 3%. Sampling error can therefore be reduced by increasing the sample size up to a certain level.²⁴⁶

8.4.1 The Sampling Process

The following six steps as outlined by Churchill²⁴⁷ served as a useful guide to the researcher in drawing the sample for this study;

1. Define the population.
2. Identify the sampling frame
3. Select the sampling procedure
4. Determine the sample size
5. Select the sample elements
6. Collect the data from the designated elements.

8.4.2 The Population

The population or the target group for this study would comprise the depositors of Bank Islam and the Muslim depositors of the interest-based banks. Because the establishment of Bank Islam is to cater for the banking needs of the Muslims it is

²⁴⁶ Most survey samples are limited to a maximum of 2000 cases since beyond this point the extra cost is uneconomical in terms of achieving greater accuracy. For example an increase from 2000 to 2500 cases only reduces the sampling error from 2.2% to 2%.

²⁴⁷ 1983:342.

decided to limit the population in this study only to Muslims. Non-Muslims who have accounts either at Bank Islam or the conventional banks would be excluded, and so would the conventional bank depositors who had accounts at Bank Islam. In other words the population of Bank Islam depositors would include those who bank exclusively at Bank Islam and those with at least two bank accounts – one at Bank Islam and the others at conventional banks. However the population of depositors interviewed at the conventional banks must not have any account at Bank Islam. Hence two population samples have been selected in this study. There were, however several options on how these two samples could be selected.

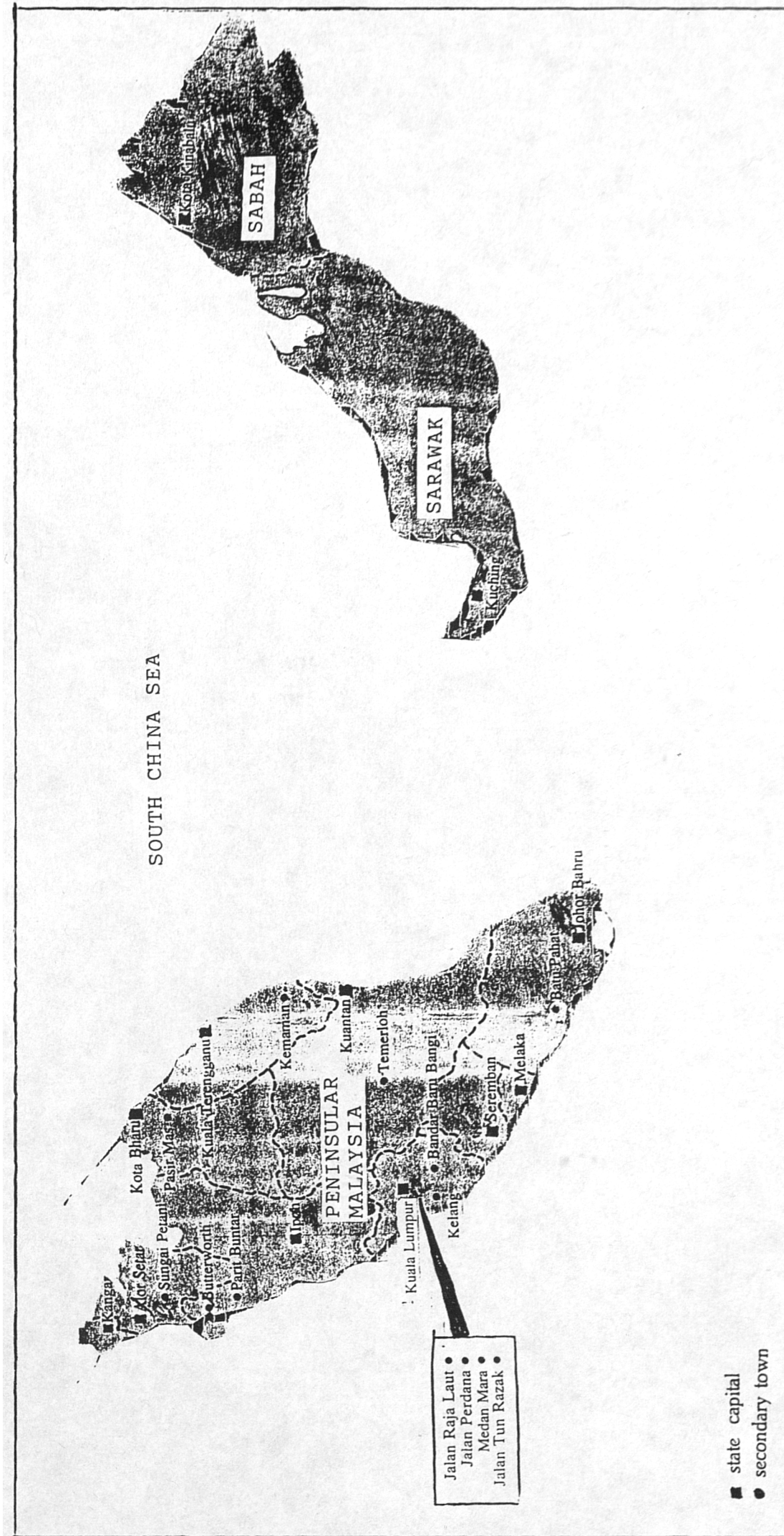
One of the possibilities was to select a representative sample of Muslim depositors from all the branches of Bank Islam in the country. Correspondingly, non-customers would be drawn from conventional banks in the same areas as the respective branches. However after reviewing the location and dispersion of the Bank Islam branches (as shown in Figure 8.1), it was envisaged that enormous resources would be required and many administrative and organizational difficulties would arise if the survey was to be conducted at all the branches simultaneously within a specified period of time period.

The most suitable method of data collection for such a sample would be the mail questionnaire but as indicated in the research literature this method usually suffers from a low response rate and requires follow-ups (and additional time and resources) if the response rate needs to be improved.²⁴⁸

Another alternative was to select customers from an urban and a rural location. At the outset such a sample would closely represent the Muslim population, which were predominantly rural, besides providing the opportunity to make inferences

²⁴⁸ Bailey 1987, Babbie 1973.

Figure 8.1 — Bank Islam Branch Network as at 31 December 1990



Source: Bank Islam Annual Report 1990

New branches in Petaling Jaya, Muar and Tampin are not shown in the map.

on the rural Muslims who were assumed to be previously unbanked and more religiously motivated than their urban counterparts. However the idea was abandoned after making the following observation. It was found that of the twenty-seven Bank Islam branches at the end of December 1990 seventeen (62.9%) were located in the capital towns²⁴⁹, as shown in Figure 8.1, and the remainder in secondary towns which were classified as urban centres.²⁵⁰ Since all the Bank Islam branches were located in the urban areas the attempt to capture the rural Muslims in this study was therefore considered not feasible.

Taking into account the limited resources available to the researcher it was decided to narrow down the alternatives within the Kuala Lumpur area where the researcher was based. As can be seen in Figure 8.1 there were four Bank Islam branches in Kuala Lumpur. Using the elimination process, branches at Jalan Tun Razak and Jalan Perdana were considered unsuitable in terms of their location and the type of customers served. The former was located within the premises of *Tabung Haji* and the latter at the Islamic Centre. It was envisaged that the sample from both branches would most likely be heavily biased towards people who work in both organizations. The representativeness of a sample from such a population would be questionable.

An observation of the locations of the Jalan Raja Laut and Medan MARA branches showed, however that both branches were conveniently located in the centre of Kuala Lumpur in an area where other conventional bank branches were also closely concentrated. As can be seen in Figure 8.2 the Jalan Raja Laut branch is almost surrounded by the branches of three of the top four domestic

²⁴⁹ capital towns can be taken as proxies for urban areas. (Shanmugam 1989).

²⁵⁰ Urban centres refer to gazetted areas with population of 10,000 or more. (Fifth Malaysia Plan 1986-1990 p 182)

banks in Malaysia (namely Malayan Banking, UMBC and Public Bank) while the Medan MARA branch is close to the branch of Bank Bumiputra the second largest domestic bank.²⁵¹ It became clear that the Jalan Raja Laut area met the criteria required for a representative sample of the depositors of Bank Islam and the conventional banks respectively. The choice of the Jalan Raja Laut area was considered justified after considering the following factors:-

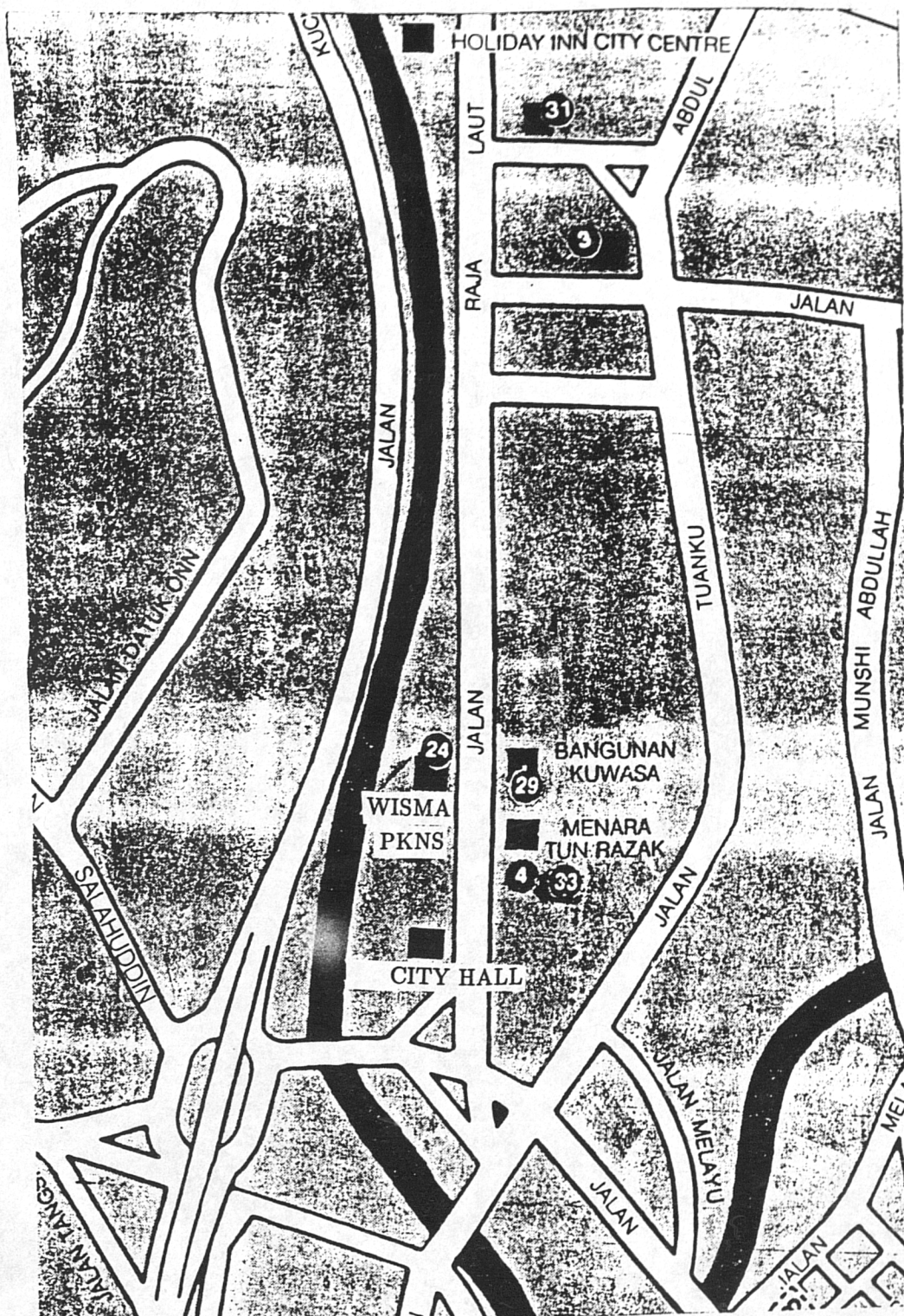
1. The Jalan Raja Laut area was situated in the heart of Kuala Lumpur. Not only was it a centre for commerce and business where people from different walks of life converged but several government departments and many private sector offices were also located within the area. As can be seen in Figure 8.2 the banks were also located between two main traffic arteries.

Based on these observations it was envisaged that the population of depositors sampled from the Bank Islam branch and the conventional banks were not likely to be biased to only one section of the urban population. The probability of selecting a bias sample of people from the same occupation, age-group, socio-economic status and education would be avoided thus enhancing the representativeness of the sample. In the case of Bank Islam, the Jalan Raja Laut branch was the first Bank Islam branch to be established in Malaysia. Because of the religious motivation, it is envisaged that the depositors of the Jalan Raja Laut Branch would also include Muslims who were based outside the Jalan Raja Laut area which would add to the representativeness of the selected sample.

2. The close proximity of the Bank Islam branch and the other conventional bank branches assured the existence of a competitive environment in which

²⁵¹ Refer to Figure 7.2 in Chapter VII to see the ranking of the domestic commercial banks

Figure 8.2 — Jalan Raja Laut: Location of Commercial banks as at 31 December 1990



- ③ Bank Bumiputra Malaysia Berhad
- ④ Bank Islam Malaysia Berhad (Jalan Raja Laut)
- ③ Bank Islam Malaysia Berhad (Medan MARA)
- ②④ Malayan Banking Berhad
- ②⑨ Public Bank Berhad
- ④③ UMBC

these banks operated. The conventional bank depositors were most likely to be aware of the existence of Bank Islam in the area and had the feasible option of selecting Bank Islam as their alternative bank. Similarly the conventional banks were easily accessible to the depositors of Bank Islam giving them the same opportunity of transferring their accounts to the interest-based banks if desired.

3. The concentration of the banks in one area fitted the resources available to the researcher. The researcher would also save a lot of travelling time between the banks when coordinating the administration of data collection.

Based on the above considerations it was decided that the sample of Bank Islam depositors was to be drawn from the Jalan Raja Laut branch and *riba* bank depositors would be selected from the branches of the following top four domestic banks in the same area namely; (i) Malayan Banking Berhad (MBB) (ii) Bank Bumiputra Malaysia Berhad (BBMB) (iii) United Malaysian Bank Corporation (UMBC) and (iv) Public Bank Berhad (PBB).

8.4.3 The Sampling Frame

The method of data collection for this study was originally planned on the assumption that the ideal sampling frame as identified in the research literature would be accessible to the researcher. The sampling frame refers to a list of all elements in the population from which the elements for the sample are to be drawn. Examples are directories, lists, records, electoral rolls and census statistics. In the case of this study the ideal sampling frames would be the lists of all depositors at

the Jalan Raja Laut branch and all depositors at the selected conventional bank branches. The availability of such lists would enable the researcher to stratify the population according to the various accounts and then select depositors from each group in proportion to the whole population. The researcher would also be able to sample the population through the use of a table of random numbers which would ensure random sampling and prevent biasness.

However after some correspondence with the Head Offices of Bank Islam and the other conventional banks it was found that accessibility to the targeted lists was not possible. The main reason given was the constraint stated in the information and secrecy clause in the 1989 Bank and Financial Institution Act.²⁵² Because of this constraint the researcher had to devise and develop alternative sampling frames. Following discussions with colleagues at the Faculty of Economics and the Statistics Department of the University of Malaya, it was decided that the sampling frame can be in the form of a specific time period during which all depositors who fulfilled the definition of the population as mentioned in the preceding section and who came to the selected bank branches would form the elements of the population and stood an equal chance of being randomly sampled.

A period of two weeks (from 23rd March 1991 until 8th April 1991) was chosen as the appropriate sampling frame. Whilst the two-week period was granted by the management of Bank Islam, Bank Bumiputra and UMBC for the survey to be carried out on their premises, only one week permission (from 28th March until 3th April 1991) was given by Malayan Banking and Public Bank. Both time periods formed good bases as both covered end of month peak periods during which many

²⁵² Under this Act any director or officer of any licensed institution is prohibited from disclosing or publishing any information relating to the affairs or account of a particular customer without the permission of the customer or to any persons other than those permitted by the Act. (Banker's Journal Malaysia December 1989:22)

customers normally visit their banks to do business.

8.4.4 The Sampling Procedure

The 'random arrival' method of sampling was chosen. By this method the daily banking opening hours were divided into one hour intervals. An interviewer would be stationed near the entrance of the bank hall and specific times within the hour would be set to select and interview a depositor at random. For example the interviewing time may be set at every 30 minutes past the hour. Thus all depositors who entered the bank hall at exactly 10.30 a.m stood an equal chance of being selected but only one will be selected at random and approached to be interviewed. If the selected depositor refused to be interviewed a new time will be set to sample the next respondent.

Table 8.1 shows the plan of the sampling procedure which was applied in sampling the depositors of Bank Islam. Two interviewers were assigned to Bank Islam. Each was required to interview one depositor at every half hour interval making a total of four respondents in every hour with the exception of certain times (for example between 2 p.m and 2.30 p.m on weekdays) as shown in Table 8.1.

Both interviewers were not allowed, however to sample two depositors at the same time. For example only one depositor who entered the hall at 10.30 a.m would be selected. Thus if interviewer A had selected a customer at 10 a.m, interviewer B would set his target time at 10.15 a.m. Since the interview was estimated to take about 20 or 25 minutes to complete, the next customer to be interviewed by A would be randomly selected from those who entered the bank hall at 10.30 a.m. The next interview by B would take place at 10.45 a.m.

Table 8.1 — Sampling Schedule of Bank Islam Depositors

Time Period 23.3.91 until 8.4.91

Number of interviewers: 2

Monday to Thursday

Time Schedule	No. of Respondents (per day)
10 a.m - 11 a.m	1 1 1 1
11 a.m - 12 a.m	1 1 1 1
12 a.m - 1 p.m	1 1 1 1
1 p.m - 2 p.m	1 1 1 1
2 p.m - 2.30p.m	1 1 - -
Total: 18 x 9=162 respondents	

Friday (2 days)

Time Schedule	No. of Respondents (per day)
10 a.m - 11 a.m	1 1 1 1
11 a.m - 11.30 a.m	1 1 - -
Friday Prayer Break	
2.45 p.m - 3.45 p.m	1 1 1 1
3.45 p.m - 4.15 p.m	1 1 - -
Total: 12 x 2=24 respondents	

Saturday (3 days)

Time Schedule	No. of Respondents (per day)
9.30 a.m - 10.30 a.m	1 1 1 1
10.30 a.m - 11.30 a.m	1 1 1 1

Total: 8 x 3=24 respondents

Total sample Size=210 respondents

The same principles of random arrival method of sampling was also applied at the conventional banks. Hence for banks which granted the two week period the daily five hours bank opening time during the weekdays (11 days) and the two hours opening time on Saturdays (3 days) were divided into one hour intervals. The same procedure was also applied to the other two banks which gave the one week permission (5 weekdays). However only one interviewer was stationed at each bank and only one respondent was required to be sampled within an hour. This was deliberately planned to allow sufficient time for the interviewer to sample a Muslim customer who did not hold any account at Bank Islam and exclude those who had.

It is worth noting that the interviewers were told to follow strictly to the time schedule and were regularly supervised to ensure that the instruction was properly carried out. By strict adherence to the set time schedule a systematic random method of sampling was therefore implemented. Every depositor who came to the selected banks during the two weeks and one week time frame stood an equal chance of being randomly selected hence avoiding the problem of sampling bias which could arise if sampling was done only on a certain day of the week or at a particular time of day only.

8.4.5 The Sample Size

The next step was to determine the size of the two samples. As discussed earlier sampling error can be reduced by increasing the size of the sample. However there is seldom a definite rule as to how large a sample should be for a given study. According to De Vaus (*op. cit*) the size of the population from which the sample is drawn is largely irrelevant for the accuracy of the sample because what is important

is the absolute size of the sample itself. As indicated by Fowler (1988) too small a sample may affect the generalizability of the study. Gay²⁵³ has however provided the following guidelines in determining the sample size;

In general, the minimum number of subjects believed to be acceptable for a study depends upon the type of research involved. For descriptive research, a sample of 10% of the population is considered minimum. For smaller population 20% may be required. For correlational studies at least 30 subjects are needed to establish the existence or nonexistence of a relationship. For causal-comparative and experimental studies, a minimum of 15 subjects per group will give some degree of confidence that conclusions reached concerning differences between groups are valid

It is also suggested that 'deciding what sample size to use is almost always a matter more of judgement than of calculation'²⁵⁴. For example if subgroups were to be analysed separately, the sample should be sufficiently large so that when it is reduced into separate subgroups, according to age, class or sex for instance, there will be enough cases in each subgroup.

Besides accuracy, time and cost are also key factors to be considered. A compromise between these three factors will determine the final sample size for a given study.

In the case of this study the sample size of the Bank Islam depositors was originally planned at 200 cases. However the time schedule allowed more depositors to be randomly sampled at the same cost. As a result a total of 210 Muslim depositors were sampled from the Jalan Raja Laut branch. It is also worth noting that the completed questionnaires were also checked frequently to count the num-

²⁵³ 1976:77.

²⁵⁴ Hoinville et al 1977:61.

ber of first customers sampled (those who opened accounts at Bank Islam in 1983) to ensure that sufficient number of cases in this subgroup²⁵⁵ were sampled so that meaningful inferences about this subgroup could be made.

The size of the sample of the Muslim depositors of the conventional banks was relatively smaller with 170 cases. This was mainly due to the relatively shorter time frame of one week granted by two of the selected conventional banks. It was noted however that even though the sample of non-customers was 40 cases less than that of the customers the difference in sampling error between both samples was marginal at 7 percentage point. Bearing in mind that the sampling error is approximately inversely proportional to the square root of the sample size, the sampling error for the customers' sample was calculated to be 6.9% at 95% confidence level compared with 7.6% for the non-customers' sample at the same level of confidence.²⁵⁶

8.4.6 The Survey Instruments

The collection of data in survey sampling can be undertaken either by using questionnaires, interviews, observations or a combination of any of these methods. Choosing the most appropriate method of data collection is one of the most far-reaching decisions that a researcher must make²⁵⁷ If data are to be collected using the questionnaire further decisions have to be made on how the questionnaire is to be administered; should it be by mail, face-to-face, in groups or individually. If the interview method is chosen on the other hand this would warrant further decisions

²⁵⁵ at least thirty as suggested by Gay (1976)

²⁵⁶ Even though the sampling errors may appear rather large, the actual sampling errors are assumed to be smaller since the population is homogeneous in terms of race and religion and great diversity is also not expected in terms of other key variables such as age, occupation and education. Moreover the sampling error for the overall group of 380 cases is 5.13% which is quite reasonable.

²⁵⁷ Fowler 1989:61.

about whether the interview will be conducted over the phone or in person. On top of this the researcher must also decide on how the questions are to be asked. Should they be open or closed? The time involved in the data collection exercise also tends to vary by mode. Some methods (such as the interview) require more trained staff than others and the mail and telephone surveys generally cost less than personal interviews. Mail surveys however are prone to low response rates. Each form of data collection therefore has its advantages and disadvantages. The researcher has to weigh the strengths and weaknesses of these methods and choose the one which suits his/her study situation.

The survey instrument adopted in this study are two questionnaires of closed-end questions which will be administered to the two samples of Bank Islam depositors and non-depositors respectively. Basically the questionnaires are designed in such a way so that most respondents will be able to fill in the answers without the aid of the interviewer. However in cases where the questionnaire cannot be self-administered the interviewer will read the questions to the respondents and record the answers. This method is known as the recording or interview-schedule²⁵⁸ in the literature. The interview-schedule is preferable when the reading and writing skills or the level of motivation of the respondent is estimated to be low²⁵⁹. Some of the respondents in this study were expected to fall into these categories and the use of the interview-schedule would help to minimize the probability of non-completion. Nevertheless the instrument used is still a set of structured questions which is the questionnaire. The interview-schedule and the questionnaire only differ in terms of the method of administration and Bailey²⁶⁰ has in fact referred to both types

²⁵⁸ Moser 1986, Bailey 1987.

²⁵⁹ Fowler 1988:63.

²⁶⁰ 1987:106

under the generic name “questionnaire”.

The decision to use closed-end questions with multiple choice answers took into account the advantages of such a method, the size of the sample, the type of population involved and the type of data to be collected.

At the outset, the questionnaire is the most widely used technique of data collection (De Vaus 1991). It is highly structured whereby each respondent is asked the same set of questions and is only required to check the proper response from a set of alternative answers provided in the questionnaire. Information gathering is therefore strictly controlled. Open-ended questions often produce all kinds of answers which are difficult to code and may not be comparable across respondents. Moreover a questionnaire which contains too many open-ended questions may frustrate the respondents. These questions may be left unanswered if the respondent finds them too demanding in terms of his time and effort which would in turn result in a low response rate which the researcher clearly wishes to avoid.

The relevance of multiple-choice questions in this study is quite apparent. It was anticipated that both speed and clarity were important in order to get a high rate of response in this study since most respondents were expected to visit the bank during the lunch hour or had taken a few minutes off their working time and hence had not much time to waste. A vast majority of the questions are therefore presented either in checklists with a list of items to choose from or in Likert-style formats with rating scales asking the respondents to indicate how strongly they agree or disagree with a certain statement. In all the questions the respondents are only required to tick the relevant box or circle a number. Complex double negative sentences, double-barelled and leading questions have also been avoided.

The objective is for the respondent to answer the questions with much ease and speed in order to acquire a high response rate.

It is worth noting, however, that some of the checklist questions are provided with the additional category called 'other (please specify)' to allow for unanticipated responses. The Likert-scale questions are also given the 'no opinion' response to avoid forcing the respondents to offer opinions on issues on which they have no opinion (De Vaus *op cit*).

For the researcher, data from closed-end questions would be relatively easier to process and analyse especially when large samples are involved. In this study data were to be collected from a large overall sample of 380 cases. Open-ended interviews may be time-consuming when administered on such a large number of respondents. Because answers might not be uniform the researcher may also misinterpret the answers and thus miscode the responses. In contrast, because standard answers can be selected from multiple-choice questions these are much easier and quicker to code with greater accuracy. This would not only save time and money but would also result in greater reliability.

Finally the multiple-choice questions suit the type of data to be collected in this study. Since the method of analysis requires nominal and ordinal data (to be discussed in detail later) the former can be obtained from the checklist format and the latter from the Likert-style questions.

8.4.7 Questionnaire Design and Pilot Tests

Before any questionnaire reaches its final draft it is usually preceded by many stages of preliminary research and pilot tests. In developing the questionnaire for

this study the researcher had consultations of successful University of Durham PhD theses also addressing Islamic banking²⁶¹, books and articles on marketing research²⁶², questionnaires of other studies on bank depositors in general²⁶³ and Islamic banking in particular²⁶⁴.

Based on the preliminary research, the first draft of two questionnaires for the two samples in this study were developed and translated into the Malay language. An important element in questionnaire design that was pointed out to the researcher was to format the questions in accordance to the computer requirement so that the data produced could be processed and analysed using the Statistical Package for Social Science (SPSS).

The questionnaires were then put through a pilot test. The questionnaire was given to eight Malaysian postgraduate students at the University of Newcastle who still held bank accounts in Malaysia. Four of these students had accounts with Bank Islam while the other four had accounts with the conventional banks. Among the aims of the pilot test were;

- to check the wording of each question in terms of clarity and understanding,
- to eliminate ambiguous and repetitive questions,
- to find out the length of time needed by respondents to complete the questionnaires and
- to identify other faults in terms of layout and the ordering of the questions.

²⁶¹ The researcher owes thanks to Dr Ramadan Shallah and Dr Saad Harran for preliminary discussions on the relevant questions that can be developed. The former has examined the experience of Islamic banking in Jordan and the latter in the Sudan.

²⁶² Churchill 1983, Dodge 1982, Ho 1987, Channon 1987.

²⁶³ Chua 1989, Bolton Committee Report 1971.

²⁶⁴ Bashir 1982, Al-Mashal 1987, Jabr 1989.

The respondents were asked to comment on the above points. Based on the comments from the pilot test several modifications were made to the wording of some questions. It was noted that since the questionnaire was to be answered by 'the man in the street' it was important to write the questions in simple Malay. Some questions considered less important to this study were omitted to reduce the length of the questionnaires. Contingency questions which applied only to certain people were also rearranged in separate sections and given clear instructions to avoid confusion.

It is worth noting that both questionnaires were again piloted for the second time in Malaysia to ensure their reliabilities. Taking into account that the first test was piloted on respondents with high academic education the questionnaires were then piloted on a different category of respondents. Six Muslim clerical staff at the Faculty of Economics University of Malaya who were depositors of the interest-based banks were asked to complete the questionnaires and give their comments. The questionnaire for the Bank Islam depositors was tested on ten employees of the Public Service Department at Wisma PKNS Jalan Raja Laut. The feedback from both pilot tests resulted in further minor modifications even though the basic content of the questionnaires remained unchanged. Finally the questionnaire was read by a senior lecturer at the International Islamic University whose area of interest was Islamic banking.²⁶⁵ After some revisions the final drafts of the questionnaires were then typed on the computer to obtain neat and good quality layouts which were aimed to encourage good response from the respondents.

²⁶⁵ Here the researcher is indebted to Zakariya Man of the Kuliyyah Economics International Islamic University Kuala Lumpur. Thanks are also due to Sulaiman Abu Bakar and Yasmin Azhar of Bank Examination Section, Central Bank Malaysia for fruitful discussions on improving the questionnaires.

8.4.7.1 Questionnaire Content

Two separate questionnaires namely the Bank Islam Depositors Questionnaire (referred to as the Bank Islam Questionnaire after this) and the Commercial Bank Depositors Questionnaire (or the Commercial Bank Questionnaire hereinafter) have been designed to obtain data from the two samples respectively. The Bank Islam Questionnaire is relatively longer and more detail than the latter in view of the fact that the subject of greater interest in this study are the depositors of Bank Islam.

As shown in Appendices G and H the front covers of both questionnaires contain brief introductions to the respondents and specific instructions to the interviewers. The respondent is assured of his/her anonymity and the confidentiality of the responses. The label Faculty of Economics University of Malaya was also printed in bold, again to encourage good participation from the respondents.

In general the question content in both questionnaires can be divided into three distinct types as classified by Dillman (1978:80) namely behaviour, attitude and attribute questions.

Part 1 of the Bank Islam Questionnaire (Appendix G) comprises behaviour questions which aim to establish the banking habit of the depositors. The respondent is asked when his/her account at Bank Islam was opened, whether other accounts are also held in the conventional banks and whether he/she had saved in commercial banks before the establishment of Bank Islam. The objective of these questions is to differentiate the different categories of Bank Islam customers and to investigate if any differences can be identified with respect to their banking habits.

The questions in Part 2 are also behaviour questions. The respondent is pre-

sented with a list of factors which may have influenced his/her decision to bank at Bank Islam. The degrees of influence are arranged in progressive order from the lowest scale 1 which measures 'no influence' to the highest scale of 5 which denotes the 'strongest influence'. The respondent is required to indicate to which extent each factor has influenced him/her to open an account at Bank Islam.

Part 3 contains a mixture of behaviour and attitude questions. Section (a) aims to elicit the respondent's awareness of the services of Bank Islam. This is followed by a question on the respondent's awareness about *riba*. The last two questions are attitude questions; the first on the difference between *riba* and interest and secondly on the imminent introduction of Islamic counters at interest-based banks.

Parts 4 and 5 are made up of attitude questions in the Likert-style format. The questions in Part 4 aim to tap the respondent's evaluation of Bank Islam in terms of its image, location and services. A short-list of services yet to be provided by Bank Islam are presented in Part 5 and the respondent is asked to tick the extent to which each service is needed.

Part 6 of the questionnaire consists of attribute questions designed to obtain information about the respondent's demographic characteristics. These include questions on his/her gender, age, education, religion, education, occupation and income. The distance of Bank Islam from the respondent's home and workplace are also of interest.

It is worth noting that many writers recommend that these personal questions are best asked at the end of the questionnaire so as not to discourage the respondent. As noted by Oppenheim (1966:57);

....such questions should come right at the end of the questionnaire, by which time we can

hope to convince the respondent that the inquiry is genuine.

The same advice is also given by De Vaus (1991:94);

Commence with questions the respondent will enjoy answering...Do not start with demographic questions such as age, marital status etc.

Finally some blank spaces were left at the end of the questionnaire in Part 7 to give the respondent an opportunity to note down any problems faced when doing business with Bank Islam and also to give suggestions if any.

The content of the Conventional Bank Depositors' Questionnaire (Appendix H) is very similar to its Bank Islam Questionnaire. However the layout of the questions can be divided into three distinct sections. The first section consists of Parts 1 and 2 which are related to the respondent's behaviour and attitude towards his/her current interest-based bank. The questions in Part 1 aim to measure how far each of the listed factors has influenced the respondent's choice in selecting the current bank while the respondent's evaluation of the bank in terms of its image, location and services is tapped in Part 2.

The second section which comprises Part 3 concerns Bank Islam and aims to elicit the respondent's awareness and perception of the Islamic Bank. All questions in this section are identical to those of Part 3 in the Bank Islam Questionnaire.

Finally the respondent's demographic characteristics are established in Part 4 which forms the third section of the questionnaire.

Similarity in question content between both questionnaires has been kept as close as possible so that comparative analyses between the two samples can be undertaken.

8.4.8 Administration of the Fieldwork

Before the main fieldwork could be carried out in the halls of the selected banks the researcher had to carry out two important tasks. The first task was to obtain permission from the Head Offices of the respective banks. For this purpose the researcher approached the Public Relation officers of the five banks. With the letter of introduction from the Deputy Dean of the Faculty of Economics University of Malaya and the Chairman of the Department of Economics University of Durham written permissions were granted by the management of the banks without much delay.

The next task was to select and train interviewers who would assist the researcher in carrying out the survey. Because the survey was to be carried out simultaneously at the five banks it was necessary to employ the services of interviewers. These interviewers play a central role in sampling the respondents, asking questions and recording the answers. Adequate training was therefore essential before the major fieldwork begins.

Fowler (1988:107-114) has listed several characteristics of 'good interviewers' which researchers should look for. Among them are:-

i) good reading and writing skills. Many survey organizations prefer interviewers who have college experience or at least completed high school.

ii) above 21 years old. Some evidence suggest that data collected by teenagers are not as good (Sudman et al 1974).

iii) an ability to work at flexible hours as surveys require interviewers to be available when respondents are available.

iv) 'a knack of instantly engaging people personally and a kind of confident assertiveness in order to enlist cooperation.'

Since the timing of the fieldwork coincided with the beginning of the long semester break of the University of Malaya the job attracted several undergraduates. However only six interviewers were required. Ad hoc interviews were conducted and eventually six third year undergraduates who fitted the above criteria were selected.

The interviewers were trained for two consecutive days. The first day was devoted to explaining various aspects of the fieldwork to the interviewers.

- The interviewers were briefed on the specific purpose of the survey and the anticipated uses of the data so that these basic information can help answer queries from respondents when enlisting cooperation.²⁶⁶
- Detailed explanation and demonstration on the random arrival sampling procedure were given. The focus of discussion was the sampling schedule (as shown in Table 8.1). The importance of strictly following this method of sampling was stressed.
- All the items in the questionnaire were discussed. The interviewers were taught the appropriate manner of approaching the respondents and enlisting cooperation. They were also reminded to ask questions exactly as written and record the answers as instructed.

The next stage was to conduct experimental interviews and role playing which are obviously one of the most important aspects of interviewer training. These

²⁶⁶ It was discovered during the fieldwork that some respondents expressed their reluctance to cooperate if the survey was carried out on behalf of political parties.

exercises, which were carried out on the second day, provide an opportunity for the interviewers to put their newly acquired skills into practice and for the researcher to provide the necessary help. The researcher conducted the first interview as an example followed by the interviewers who took turns playing the roles of respondent and interviewer.

After the intensive training programme the interviewers were ready to begin the fieldwork on the designated day. Two interviewers were based at the Bank Islam branch while the other four were assigned to each of the four conventional banks respectively. Each interviewer was introduced to the respective bank managers for the purpose of identification and was also made to wear a photo name-tag for the same purpose.

The following points were noticed during the fieldwork.

- A vast majority of the respondents were happy to answer the questionnaire when approached by the interviewers. Those who refused for the first time were offered an incentive of M\$5. The response rate was 100% as all questionnaires were completed.
- Self-administered questionnaires at Bank Islam took about 10 minutes to complete while those conducted by the interview-schedule took about 20 to 25 minutes at Bank Islam and 15 minutes at the conventional banks. It was found that most respondents at Bank Islam preferred the interview-schedule while both methods were frequently used at the conventional banks.

It is important to note that even though the fieldwork was carried out by the interviewers it was consistently supervised by the researcher who made frequent rounds to the five bank branches which were located almost next door to each

other. To monitor the job each interviewer was required to fill in the day and time of each interview as well as his name on the front cover of each questionnaire. The completed questionnaires were collected and checked by the researcher at the end of every working day.

8.5 Statistical Techniques and Data Treatment

The collected data were brought back to the University of Durham to be processed and analysed. The data were first coded and entered into columns so that analysis by the SPSS computer programme could be carried out.

To analyse the data both descriptive and inferential statistics would be utilized. Descriptive statistics are those which summarize the data and describe the pattern of responses obtained from the questionnaire. These statistics include frequency distributions, histograms and bar charts. However in this study only frequency distributions will be used to see the number of cases that fall into each category. These distributions will be summarized by measures of central tendency such as the median, mode and mean.

Central tendency is one of the most important ways of summarizing a distribution of values for a variable as it indicates the most typical value in the distribution.²⁶⁷ The mean may be the most well-known measure of central tendency compared to the median and the mode. However whether the mean, median or mode should be used depends largely on whether the variables to be analysed are nominal, ordinal or interval. In the case of this study reference will be made to the guidelines as shown in Table 8.2 in choosing the most appropriate measure.

²⁶⁷ Bryman 1991: 82.

Table 8.2 — Appropriate Measures of Central Tendency

Variable level	Central tendency	Dispersion
1. Nominal	Mode	variation ratio
2. Ordinal	Median/ Mode	decile range
3. Interval	Mean/ Median	standard deviation

Whilst the purpose of using descriptive statistics was to summarize the data, detect missing or miscoded data and derive important information about the typical distribution of each variable, two other salient aspects of data analysis in this study are factor analysis and testing the association between key variables by using inferential statistics.

The technique of factor analysis is employed to analyse the data collected for Part 2 and Part 1 of the Bank Islam and the Conventional Bank questionnaires respectively. Its purpose is to identify which variables constitute the main bank selection criteria for the depositors of both banks. Given the list of fourteen likely variables in the Bank Islam Questionnaire, it is possible to reduce this large set, by factor analysis, to a smaller set of more general underlying factors – each group of factors having certain characteristics in common or are measuring the same underlying dimension.

The extraction of these groups of factors is based on the correlations between the variables whereby only factors having *eigenvalues* (to be explained later) greater than one are considered significant. Since this technique is best explained with the data it will be discussed further in Chapter IX.

Having identified the main motivational factors for the main samples further analysis can be done using inferential statistics to test the hypotheses designed for

the subgroups. The relevance of inferential statistics lies in the fact that inferences can be made from the sample to the population; specifically whether the trends described in the sample are likely to represent the population from which the sample is drawn. In the case of this study, inferences will be based on the tests of statistical significance at the 0.05 level.²⁶⁸

A number of statistical techniques have been designed to test the relationship between two variables. These techniques are classified as bivariate methods of analysis and here again certain rules of thumbs can be referred to in deciding which methods are appropriate for this study as shown in Table 8.3.

Based on Table 8.3 the relevant inferential statistics in this study would be the chi square to test the relationship between nominal variables; and the Mann-Whitney U-test and the Kruskal-Wallis tests when the combinations are between ordinal and nominal variables. In addition the Spearman Rank Correlation would also be utilized to measure the relationship between the ordinal variables.

The purpose of the chi square test is to see if two variables of a crosstabulation are *statistically independent*. In this test the null hypothesis is phrased to state that no relationship exists between the two variables. If the null hypothesis cannot be rejected using the chi-square statistics this implies that the two variables do not have anything in common and hence are statistically independent of each other. It is worth noting, however that the chi-square only tests the relationship or association between two variables and does not indicate which causes the other.

²⁶⁸ As a rule of thumb 0.05 is appropriate for small samples and 0.01 or lower for larger samples (De Vaus 1991:191).

Table 8.3 — Guidelines for Selecting Measures of Associations

Variables (level of measurement)	Appropriate Methods	Inferential Statistics
1.Nominal/nominal	Crosstabulations	chi square
2.Ordinal/ordinal (many categories)	Rank Correlation	Test of significance of Spearman's rho
3.Interval/interval (few categories)	Crosstabulations	Test for significance of Pearson's r
4.Nominal/ordinal (dichotomous nominal variable) (nominal variable more than 2 categories)	Crosstabulations	1. Mann-Whitney U-test 2. Kruskal-Wallis test
5.Nominal/interval	Comparison of means	F-test (one-way analysis of variance)
6.Ordinal/interval	Rank correlation	Test for significance of Spearman's rho
7.Interval/interval	Scattergram	

Source: Derived from De Vaus (1991) Table 11.5

On the other hand, both the Mann-Whitney U-test and the Kruskal-Wallis test are nonparametric or distribution-free tests which require less strict assumptions about the underlying population and the type of data to be analysed. Unlike parametric tests (such as the F-test and the t-test) which require data to be measured on interval levels and that samples are drawn from normal populations, nonparametric tests do not require the shape of the underlying distribution to be specified even though samples need to be selected at random. As stated by Norusis (1988:139);

When data are ordinal – or interval but from a markedly nonnormal distribution – the Mann-

Whitney test is the procedure of choice....Significant levels for nonparametric tests can be determined regardless of the shape of the population distribution since they are based on ranks.

Nonparametric tests can also be used on nominal data. As indicated by Siegel (1956:33);

Nonparametric methods are available to treat data which are simply classificatory, i.e., are measured in a nominal scale. Non- parametric technique applies to such data.

Last but not least, these tests have the advantage of being applicable on small samples. This is again confirmed by Siegel (1956:32) who states;

If sample sizes as small as $N=6$ are used, there is no alternative to using a nonparametric statistical test unless the nature of the population is known exactly

In relation to the Mann-Whitney U-test Siegel also adds that the test is;

one of the most powerful of the nonparametric tests, and it is a most useful alternative to the parametric t-test when the researcher wishes to avoid the t-test's assumptions (p. 116)

Both the Mann-Whitney and the Kruskal-Wallis tests will be used to explore the differences between scores on two variables. For example to find out if depositors and non-depositors differ in terms of their income. Since there are only two groups (depositors and non-depositors) to be compared the Mann-Whitney test will be used.²⁶⁹ It will compare the number of times a score from one of the samples is ranked higher than a score from the other sample. If the two groups are similar, then the number of times this occurs should also be similar for the two groups. (Bryman 1990:129).

²⁶⁹ The Kruskal-Wallis test is applicable to variables having more than two categories.

Chapter IX

Findings and Analysis

9.1 Introduction

In line with the main objectives of the survey as stated earlier in Chapter VIII the statistical analysis in this chapter is generally concerned with three main aspects;

1. to test several hypotheses about the depositors of Bank Islam including those considered by earlier researchers on Islamic banking in Malaysia.
2. to identify the main factors influencing bank selection decisions among Muslim depositors in Malaysia, specifically the depositors of Bank Islam and the depositors of the conventional bank.
3. to examine the market implications of the obtained results in order to gain some insights to how a bigger market can be captured.

9.2 Analysis of Bank Islam Depositors

As discussed in Chapter VIII (Section 8.3.1) the depositors of Bank Islam can be divided into two main categories; namely those who bank only at Bank Islam and those with other accounts in conventional banks. Which of these two groups of depositors forms the majority of Bank Islam depositors would reflect the success of Bank Islam in providing an Islamic alternative to western banking. If a majority of depositors bank only with Bank Islam this may imply that the Bank

has exerted a great impact on mobilizing savings without interest. Man (1986:87), however envisaged that a majority of depositors would not bank exclusively with Bank Islam and still maintain contacts with the conventional banks.

To assess this expectation the following null hypothesis was tested.

- H_0 : The depositors of Bank Islam are equally distributed between depositors who bank only at Bank Islam and depositors who hold other accounts in conventional banks.

The survey finding as shown in Table 9.1 seems to agree with Man's viewpoint.

Table 9.1 — Frequency Distribution of Bank Islam Depositors

Do you have accounts in other banks?	Frequency	Per cent	Cumulative Per cent
Yes	129	61.4	61.4
No	81	38.6	100.0
Total	210	100	

Table 9.1 shows that more than half (61.4 per cent, N=129) of Bank Islam depositors had accounts in other banks and only 38.6 per cent (N=81) bank exclusively at Bank Islam. The null hypothesis can therefore be rejected which implies that a majority of depositors do not typically bank only at Bank Islam but hold other accounts in the conventional banks too.

We shall examine each category of depositors in turn.

9.2.1 Depositors who bank exclusively at Bank Islam

It is generally assumed that because this group of depositors do not hold ac-

counts in the conventional banks they are the pious Muslims who are conscious of avoiding *riba* or interest as required by the *Shariah*. It is assumed that these depositors had never saved in traditional banks because of the presence of interest and became newcomers of the banking system with the establishment of the Islamic bank. How far these assumptions are true can be further examined. The following null hypothesis will be first tested.

- H_0 : Depositors who bank only at Bank Islam typically held accounts in conventional banks previously.

**Table 9.2 — Frequency Distribution: Held Conventional Bank
Accounts Previously**

Did you save in commercial banks before?	Frequency	Percent	Cumulative Per cent
Yes	55	67.9	67.9
No	26	32.1	100.0
Total	81	100.0	

The frequency distribution in Table 9.2 shows that 67.9 per cent (N=55) of these depositors had accounts in conventional banks previously. Only 32.1 per cent were newcomers into the banking system. This finding suggests that the null hypothesis cannot be rejected which implies that **a majority of depositors who now bank only at Bank Islam are not new depositors because they have had accounts in conventional banks previously.**

To some extent this finding seems to support the view that Muslims in urban areas have developed the banking habit and are therefore likely to have kept their money in traditional banks before the establishment of Bank Islam. This leads to

an important implication for the market; that the establishment of Bank Islam branches in the urban areas has only effected a transfer of resources within the market with little impact on mobilizing new deposits which the interest-based banks has previously failed to attract because of *riba*. This result seems to support the general view that the impact of Islamic banking in deposit mobilization in the urban areas is expected to be marginal compared to its potential in the rural areas. It is envisaged that new deposits for Bank Islam can be mobilized more from the rural areas where a sizeable portion of savings are being hoarded because of the the absence of *halal* outlets. The findings of Professor Ungku Aziz in the late 1950s had shown that Muslims in the rural areas were highly pious and had preferred to hoard their savings rather than save in the interest-based banks. It would be of great interest to find out if such behaviour still exists today and test the impact of Islamic banking on the mobilization of these rural savings. However as mentioned earlier, it is not possible to carry out such investigation within the scope of this study owing to the fact that the present network of Bank Islam branches are concentrated in the urban areas.

This study has also identified the depositors' main reasons for saving in conventional banks before. During the survey the depositors were asked to indicate three main reasons why accounts were kept in interest-based banks before. The responses to this question were expected to support the hypothesis by Mohd Yacob that 'some of them have been saving with conventional banks for safe-keeping and convenience.'

Our findings are shown in Table 9.3 which indicate that deposits were made in conventional banks before the establishment of Bank Islam for purposes other than interest. About 20 per cent of the responses (N=34) indicated that in the

absence of the Islamic bank there was no other alternative but to keep their money in the conventional bank. 11.9 per cent indicated that their salaries were credited directly into the commercial bank and another 9 per cent trusted the banks for the safety of their money. All three reasons seem to indicate one common purpose among the depositors, that is, to ensure the safety of their money. This further supports the argument that Muslims in urban areas had already developed the banking habit before the establishment of Bank Islam. The second motivating factor was convenience. 19.6 per cent of the responses indicated that they were motivated by the close proximity of the conventional bank to their place of work. This finding therefore supports the hypothesis by Mohd Yaacob. It is clear that even though depositors who bank exclusively at Bank Islam had held accounts in conventional banks before, these accounts were kept as a means to safeguard the safety of their money and for convenience rather than for the aim of earning interests.

Table 9.3 — Frequency Distribution: Purpose of Saving in Conventional Banks before.

Why did you save in commercial banks before?	Frequency	Percent	Cumulative Percent
No Bank Islam branch	34	20.2	20.2
Near to workplace	33	19.6	39.8
Salary paid in the bank	20	11.9	51.7
Safety of money	15	9.0	60.7
Others(Miscellaneous)	41	24.4	85.1
(gives only 2 reasons)	25	14.9	100.0
Total	168*	100.0	

Note: * refers to total response, not cases since each respondent were asked to give 3 main reasons (i.e 3 x 56).

9.2.2 Depositors With Other Accounts in Conventional Banks

As shown earlier this group forms the majority of Bank Islam depositors as more than half (61.4 per cent) of the sampled population belonged to this group. This raises the question of the type of accounts held and the reason for opening these accounts.

Man (1986) believes that depositors would hold current account in the conventional banks, presumably for transactional purposes as these accounts do not yield any interest.

Our results show that only a few depositors had current accounts in the conventional banks. A majority of accounts were in the form of savings. As can be seen in Table 9.4, 79 per cent (N=102) of these depositors had savings account in conventional banks. 13.2 per cent had current accounts and an insignificant 2.3 per cent made fixed deposits.

Table 9.4 — Frequency Distribution: Type of Account In Other Banks

What account do you hold in the other banks?	Frequency	Per cent	Cumulative Percent
Savings account	102	79.1	79.1
Current account	17	13.2	92.2
Fixed deposit	3	2.3	94.6
Savings & Current	7	5.4	100.0
Total	129	100.0	

The high proportion of savings account held can be explained by the fact that these accounts were relatively easy to open. Compared to the current account

which requires an introducer and a minimum deposit of M\$500 anybody can open a savings account with a deposit as little as M\$1.

**Table 9.5 — Crosstabulation: Type of Account in other banks BY
Income; Controlling for Account in other bank? Value=Yes**

Type of account	Income			Row Total
	700 & below	701-1400	1401 & above	
Savings	37	37	13	87
row %	42.5%	42.5%	14.9%	100%
Current	4	9	10	16
row %	17.4%	39.1%	43.5%	100%
Column Total	41	46	23	110
	37.3%	41.8%	20.9%	100%

chi-square=10.20 d.f= 2 Significance= 0.00604

It is obvious that the current account requirements can generally be fulfilled by depositors with high income. A crosstabulation between the type of account held in other banks and the income of these depositors seems to confirm this. As can be seen in Table 9.5 even though depositors at all levels of income tend to hold more savings rather than current accounts it is apparent that the current account is least held by those with low income (17.4%) while savings is least popular among the high income group (14.9%). This relationship is supported by the chi-square value of 10.20 which is higher than the critical chi-square statistics ($\chi^2=5.99$) at 0.05 level of significance and 2 degrees of freedom.²⁷⁰ The null hypothesis of no association between the type of income held and income is rejected. The result

²⁷⁰ The degree of freedom for the chi-square statistic is calculated as $(r-1)(c-1)$ where r =number of rows and c =number of columns of the crosstabulation.

is likely to hold in the population since the observed significance level (0.00604) is lower than the 0.05 confidence level. It can therefore be inferred that savings accounts in the conventional banks are most likely to be held by low income and middle-income earners and the current accounts are most likely to be held by those with high income. **It can therefore be inferred that the additional accounts maintained in the conventional banks are mainly in the form of savings accounts belonging to low and middle income depositors whilst a smaller percentage of current accounts tend to be held by those with high income.**

In relation to the high proportion of savings accounts held in the conventional banks is the question of whether this group of depositors are after all attracted by the higher rates of interest offered by these banks.

Our findings in regard to this question are presented in Table 9.6. It is evident from this table that the relatively higher rates of interest had very little impact on these depositors. Only 1 per cent of the responses indicated that savings were made in the conventional banks because of the higher rates of interests offered on deposits. Conversely, a greater percentage of responses show the importance of factors related to convenience namely the number of bank branches (22.5%), the availability of ATMs (21.2%) and locational convenience especially from home (11.1%). Apparently these are the three factors that Bank Islam lacks at its present stage of development.

This finding suggests that even though a high proportion of Bank Islam depositors hold interest-bearing savings accounts in other banks they were not typically attracted by the higher rates of interest paid on

these accounts. Deposits were made in the conventional banks mainly for the purpose of convenience specifically to take advantage of the many branches and the ATM facility which Bank Islam still lacks. Other things being equal it is expected that this group of depositors will transfer all their accounts to Bank Islam once these facilities are made available in future.

Table 9.6 — Frequency Distribution: Reasons for Deposits in Other Banks

Why do you also save in other banks?	Frequency	Percent	Cumulative Percent
1.Many branches	87	22.5	22.5
2.ATM available	82	21.2	43.7
3.Near home	43	11.1	54.8
4.Near workplace	40	10.4	65.2
5.Near to where I shop	31	8.0	73.2
6.Wellknown	23	6.0	79.2
7.Fast and efficient service	16	4.1	83.2
8.Salary paid there	16	4.1	87.3
9.Higher Interest rates	4	1.0	88.3
(gives only one reason)	45	11.6	100.0
Total	387*	100	

Note: * refers to responses, not cases since respondents were asked to give three main reasons. (i.e 3 reasons x 129 cases)

Nevertheless, our findings seem to suggest that accounts held in the conventional banks were mainly supplementary accounts. As evident in Table 9.7, Bank Islam is typically the primary bank for these depositors because 72 per cent (N=93)

had more savings in Bank Islam than the conventional bank and 58 per cent did more business or had more transactions at Bank Islam compared to the conventional bank.

Table 9.7 — Frequency Distribution: Bank with more savings and transactions

In which bank do you have more savings?	Frequency	Per cent	Cumulative Per cent
Bank Islam	93	72.1	72.1
Conventional bank	36	27.9	100.0
Total	129	100.0	
In which bank do you have more transactions?			
Bank Islam	75	58.1	58.1
Conventional bank	54	41.9	100.0
Total	129	100.0	

In summary the results in the preceding section show that Bank Islam depositors are generally not influenced by interest-rates offered by the conventional bank.

9.2.3 Religiosity: Comparison Between the Two Groups

To see if there are differences in the behaviour of these two groups in terms of their religious commitment in avoiding *riba* two hypothetical questions (see items B.1 and 2 in Part Two of the Bank Islam Questionnaire) were put forward in the questionnaire to test the following null hypotheses.

1. H_0 : Depositors who bank only at Bank Islam and depositors with accounts in conventional banks are equally likely to close their account at Bank Islam

if the rates of profit on savings are less competitive than the rates of interest on savings at conventional banks.

Table 9.8 — Crosstabulation: Bank Loyalty BY The Two Main Groups of Depositors

Will close account?	Account in Bank Islam Only	Account in Other Banks Also	Row Total
Yes column %	0 0%	6 4.7%	6 2.9%
No column %	81 38.6%	123 95.3%	204 97.1%
Column Total	81 38.6%	129 61.4%	210 100%

chi-square =3.878 d.f= 1 Significance= 0.04892

Table 9.8 shows that those who bank only at Bank Islam are likely to be more committed in avoiding *riba*. None of these depositors would close their accounts at Bank Islam if the rates of profit paid on their savings cannot compete with the interest on savings in conventional banks. On the other hand about 4.7 per cent (N=6) of those with other accounts in conventional banks would consider closing their accounts at Bank Islam.

Even though the chi-square value (3.878) is quite small it is well above the critical chi-square value 3.841 at 0.05 confidence interval at one degree of freedom. The null hypothesis of no association is rejected which implies that the two groups of depositors are likely to differ in their loyalty to Bank Islam if the rates of profit

on savings are relatively lower than interest on savings at conventional banks. These differences are likely to hold in the population since the observed significance level ($P=0.0489$) does not exceed the 0.05 confidence level. It can therefore be inferred that **depositors who bank only at Bank Islam are relatively more committed in avoiding *riba* and can be regarded as the loyal customers of the Bank.**

Another appropriate measure of depositors' commitment in avoiding *riba* is their unwillingness to invest in the *Amanah Saham Nasional* (ASN) unit trust scheme. On the assumption that all the depositors of Bank Islam have the ability to pay²⁷¹ it is envisaged that only Muslims who are strongly committed to avoiding *riba* would not participate in this scheme on the basis that some of the ASN investments are held in the shares of interest-based banks.

The following null hypothesis was tested.

2. Null hypothesis H_0 : Depositors who bank exclusively at Bank Islam and depositors who hold other accounts in conventional banks are equally likely to invest in the ASN.

Even though the figures in Table 9.9 suggests that Bank Islam depositors do not typically buy ASN shares (mode= 126, 60%), it is also evident that more than half (50.4 percent, $N= 65$) of those with accounts in conventional banks had made such investments. In contrast less than a quarter (23.5%, $N=19$) of depositors who banked exclusively at Bank Islam did not invest in the ASN. This pattern of investment behaviour seems to suggest that there is a relationship between depositors who avoided the interest-based banks and their unwillingness to invest

²⁷¹ As described in Chapter V, a unit holder in the ASN scheme is required only to pay M\$10 or the equivalence of 2 to participate in this scheme.

in the ASN. This is confirmed by the chi-square test, which shows a chi-square value=15.037 which is higher than the tabulated chi-square value (3.841) at the 0.05 confidence level, at 1 degree of freedom. The null hypothesis of no association can therefore be rejected and this is likely to hold in the population since the observed significance level ($P=0.0001$) is lower than the 0.05 critical point. It can therefore be inferred that **depositors who bank exclusively with Bank Islam are less likely to invest in the ASN compared to the other group of depositors.** Since the ASN investments are also held in the *riba* banks the above finding suggests that **depositors who bank exclusively at Bank Islam are relatively more committed in avoiding *riba*.**

Table 9.9 — Crosstabulations: ASN BY Category of Depositors

invest in ASN?	Account in other banks also	Account in Bank Islam only	Row Total
Yes	65	19	84
row %	51.6%	32.4%	(40.0%)
column %	50.4%	23.5%	
No	64	62	126
row %	77.4%	48.6%	60.0%
column %	49.6%	76.5%	
Column Total	129	81	210
	61.4%	38.6%	100%

chi-square= 15.0367 d.f= 1 Significance=0.00011

Thirdly, depositors commitment in avoiding *riba* can also be measured by their willingness to bank only with another Bank Islam branch if the present branch is forced to close. It is envisaged that pious depositors would prefer to bank only

with an Islamic bank once the facility is introduced in the market. A strong motivation to avoid *riba* would be reflected by the willingness to remain with the Islamic bank even if it required some sacrifice in terms of convenience. On the other hand, depositors who attach more importance to convenience rather than the religious motivation to avoid *riba* are likely to prefer the nearest bank, even if it is a conventional bank. Based on our earlier findings, it is hypothesized that depositors who bank exclusively at Bank Islam are likely to be more committed to remain with Bank Islam compared with depositors who bank both at Bank Islam and the conventional banks. As shown in Question B.2; Part Two of the Bank Islam Depositors Questionnaire; depositors were asked to indicate their next bank choice if the present branch were to close. The purpose of the question was to test the following null hypothesis.

3. Null hypothesis H_0 : Depositors who bank exclusively with Bank Islam and depositors who bank both with Bank Islam and the *riba* banks are equally likely to choose another Bank Islam branch if the present branch closes.

The results of the crosstabulation in Table 9.10 show that unlike the previous hypothesis, it is evident that there is no difference between the behaviour of the two groups in this case. A majority of depositors in each group had chosen to bank with another Bank Islam branch even if it meant going to another area to do their banking. The computed chi-square value (0.887) is lower than the tabulated chi-square statistic (3.841) at the 0.05 and 1 degree of freedom critical point. This implies that the null hypothesis that both groups of depositors are equally loyal to Bank Islam cannot be rejected. It can therefore be inferred that **Bank Islam depositors are generally loyal to the bank and are not likely to trade interest-free banking for convenience.**

Table 9.10 — Crosstabulation: Next Bank Choice BY The Two Main Groups of Bank Islam Depositors

Next Bank Choice	Accounts in Bank Islam only	Account in Other Banks too	Row Total
Other bank in this area	22	43	65
row %	33.8%	66.2%	(31.0)%
column %	27.2%	33.3%	
Bank Islam in another area no matter how far	59	86	145
	40.7%	59.3%	(69.0)%
	72.8%	66.7%	
Column Total	81	81	210
	61.4%	38.6%	100%

chi-square= 0.887 d.f= 1 Significance= 0.346

In summary, the profile of the urban depositors of the Islamic bank in Malaysia is characterized by

i) a majority of depositors holding secondary accounts in the interest-based banks; not to earn interest but mainly for the purpose of convenience specifically to take advantage of the extensive branch network and the ATM facility which the Islamic bank still lacks.

ii) depositors who are not new entrants to the banking system which implies that the establishment of Islamic banks in the urban areas has little impact in mobilizing new deposits which were not mobilized previously by the interest-based banks. However depositors who bank exclusively with Bank Islam are more religiously committed in avoiding *riba* in the form of interest or in interest-related investments.

iii) depositors who have a strong loyalty to Islamic banking as reflected by their willingness to remain as depositors even if it involves some sacrifice of convenience.

9.3 Factor Analysis: Selection Criteria (Bank Islam Depositors)

The findings in the preceding sections seems to suggest that Bank Islam depositors are generally not concerned with the rates of returns on their savings. Depositors are in general religiously committed in abiding by the Islamic ban against *riba*. Even though there seems to be some trade-off between the religious motivation and convenience as reflected by the high proportion of accounts still held in conventional banks it has not been established whether depositors are motivated to bank with Bank Islam because of the convenient location of the bank branch or because of the religious motivation. This section will attempt to determine which of these two factors is the stronger motivation. The method of factor analysis will be applied. This is because factors such 'religious motivation' and 'convenience' have many connotations. As noted by Norusis²⁷² such factors are not single measurable entities but are the constructs of a number of other directly observable variables. By factor analysis these observable variables can be clustered into factors, each reflecting an underlying property (such as convenience) which is commonly shared by a certain group of variables.

In this analysis, a list of fourteen variables²⁷³ which are likely to have influenced depositors' decision to choose Bank Islam as their primary bank will be factor analysed. There are four steps in factor analysis (Norusis 1988:201, De Vaus 1991:258) which involve namely;

²⁷² 1985:128

²⁷³ as shown in Part Two of the Bank Islam Depositors' Questionnaire

1. The selection of variables to be factor analysed.
2. The extraction of an initial set of factors.
3. The extraction of the final set of factors by rotation.
4. The computation of scores for each factor for use in subsequent analysis.²⁷⁴

9.3.1 STEP 1: Is Factor Analysis Feasible?

The first step in factor analysis is to determine whether the variables in the data set contain the ingredients for a successful factor analysis. There are different ways of checking this and we shall consider each in turn.

(i) The Correlation Matrix

First, a correlation matrix for the 14 variables (as shown in Table 9.11) is produced to see whether each variable correlates reasonably well (at least with a correlation coefficient of 0.09) with at least one of the other variables in the set. This is because low correlations between variables would imply that they do not share common factors and the use of factor analysis would not be appropriate. The correlation matrix in Table 9.11 shows that the fourteen variables have sufficiently large correlations as required which means that all of them may be factor analysed.

²⁷⁴ This step will not be carried out in this study since our main aim is only to identify the factors.

Table 9.11 — Correlation Matrix: Variables-ENFR TO BRCH

	ENFR	PUBLIC	DWRK	NORIB	LNORIB	PLSINV	DHOME
ENFR	1.00000						
PUBLIC	.29602	1.00000					
DWRK	.19982	.27084	1.00000				
NORIB	.04085	.21215	.14363	1.00000			
LNORIB	.08439	.04243	.10938	.41310	1.00000		
PLSINV	.10488	.17798	.07893	.43228	.59771	1.00000	
DHOME	.10713	.20279	.40290	.14658	.08623	.14974	1.00000
PRSAV	.08186	.18102	.03435	.46352	.35614	.49043	.21736
ISLM	-.02068	.12317	-.10633	.22352	.12610	.13452	.00999
PARK	.16433	.14553	.02321	.02171	.09157	.03689	.24353
PTRP	.07645	.28495	.23901	.18127	.03624	.16944	.26500
TYPLOAN	.11691	.15769	.16043	.20461	.44790	.39088	.08815
LOAN	.20485	.17023	.14563	.16564	.46189	.33770	.11146
BRCH	.21561	.21813	.26025	.11979	.16398	.19051	.36222
	PRSAV	ISLM	PARK	PTRP	TYPLOAN	LOAN	BRCH
PRSAV	1.00000						
ISLM	.23945	1.00000					
PARK	.00650	-.09485	1.00000				
PTRP	.16313	-.02143	.53782	1.00000			
TYPLOAN	.24355	.10163	.33997	.31983	1.00000		
LOAN	.25653	.09513	.36995	.27433	.84263	1.00000	
BRCH	.12275	.09751	.26962	.37382	.28342	.33323	1.00000

KAISER-MEYER-OLKIN MEASURE OF SAMPLING ADEQUACY = .73335

BARTLETT TEST OF SPHERICITY = 919.10796, SIGNIFICANCE = .00000

(ii) The KMO statistic

The relevance of factor analysis for the data set may also be determined statistically. The first statistics called the Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy, is an index which compares the observed correlation coefficients between pairs of variables to the size of the partial correlation coefficients when the linear effects of other variables are eliminated.²⁷⁵ The rule is, variables which share common factors should have small partial correlation coefficients. Hence if the sum of the squared partial correlation coefficients is small when compared to the sum of the squared correlation coefficient, the KMO value is close to 1. Small KMO values indicate that factor analysis is not suitable, since correlations between pairs of variables cannot be explained by the other variables. Kaiser (1974) regards KMO=0.9 as marvellous, 0.8 as meritorious, 0.7 as middling, 0.6 as mediocre and 0.5 and below as miserable.²⁷⁶ In the case of this study the KMO value for the data set is found to be average at 0.73335 which indicates that factor analysis would be feasible.

(iii) The Bartlett Test of Sphericity

This test is used to test the null hypothesis that the correlation matrix is an identity matrix. Variables do not share common factors in an identity matrix where all the diagonal terms are 1 and all the off-diagonal terms are zero. The calculation of the Bartlett Test value for the correlation matrix in Table 9.11 shows a very high value (919.1) and an associated probability ($P=0.000$) which is lower than the 0.05 level of statistical significance. The null hypothesis that the correlation matrix is an identity can be rejected. This suggests that factor analysis can be

²⁷⁵ Norusis 1985:129.

²⁷⁶ Norusis 1985:129.

applied to the data since it is unlikely that the correlation matrix is an identity.

The results of these three indicators show that all fourteen variables can be retained for factor analysis in order to identify a smaller set of factors that have influenced depositors to select Bank Islam as their primary bank.

9.3.2 STEP 2: Initial Extraction (How many factors?)

Since the objective of factor analysis is to extract as few factors as necessary the researcher has to determine the suitable number of factors to be extracted.

At the initial stage factor analysis will extract as many factors as there are variables using principal-component analysis. As explained by Bryman²⁷⁷:

[In principal-component analysis] the first component or axis that is extracted accounts for the largest amount of variance shared by the tests. The second factor consists of the next largest amount of variance which is not related to or explained by the first one. In other words, these two factors are unrelated or orthogonal to one another. The third factor extracts the next largest amount of variance, and so on. There are as many factors as variables, although the degree of variance which is explained by successive factors becomes smaller and smaller. In other words, the first few factors are the most important ones.

It is worth noting that specifying the number of factors to be extracted is not a straightforward process. It requires trial runs extracting various numbers of factors before the most appropriate number is selected. In some cases the aid of subjective judgement is also necessary.²⁷⁸ For this study several runs of factor analysis were tried to extract 4 through 6 factors consecutively. The results were then compared

²⁷⁷ 1991:258.

²⁷⁸ Jaeger 1990:357.

and analysed. In the final analysis it was found that the extraction of four factors seems more justified based on the following guidelines.

- Guideline 1: The *Eigenvalues*

Table 9.12 shows that initially factor analysis will extract fourteen factors from the fourteen variables. One of the purposes of the initial extraction is to show the *eigenvalues* or variance accounted by each factor and the cumulative percentages of these variances which will help to determine the number of factors to be extracted.

There are two parts in Table 9.12. The first part is represented by the first two columns which provide information about each of the fourteen variables. The second part which comprises the last four columns describes the factors. The variable names are listed in Column 1. The *communality* in Column 2 indicates the amount of variance that each variable explains. Since 14 factors have been extracted from 14 variables this implies that each variable will have a variance or *communality* of 1.²⁷⁹ Column 3 lists the 14 factors that have been extracted. The total variance explained by each factor or the *eigenvalue* is listed in Column 4 while the percentage of the total variance²⁸⁰ attributed to each factor is shown in Column 5 with the cumulative percentages in column 6. For example 73 per cent of the total variance is attributable to the first six factors.

Thus the information in the first row indicates that the ENFR variable has a communality or variance of 1.²⁸¹ The first factor extracted; Factor 1 has an

²⁷⁹ All the fourteen variables are expressed in a standardized form with a mean of 0 and a standard deviation of 1. Each variable is therefore standardized to have a variance or communality of 1 (Norusis 1985:130).

²⁸⁰ The total variance is 14 since 14 factors has been extracted.

²⁸¹ Since 14 factors have been extracted from 14 variables this means that one variable will represent one factor. If less than 14 factors are extracted then the communality of each variable will be less than 1. A variable with a high communality of 0.8 for example, will indicate a high correlation between that variable and other variables with which it shares a common factor.

eigenvalue of 3.880 which accounts for 27.2 per cent of the total variance. 14.3 per cent of the total variance will be explained by the second factor. Hence if only two factors are extracted in this analysis the total variance explained will be 42 per cent.

Table 9.12 — Initial Extraction:Initial Statistics
(Principal-Components Analysis)

VARIABLES		FACTORS			
Variable	Communality	Factor	Eigenvalue	% of variance	Cumulative %
(1)	(2)	(3)	(4)	(5)	(6)
ENFR	1.000	1	3.880	27.7	27.7
PUBLIC	1.000	2	1.997	14.3	42.0
DWRK	1.000	3	1.422	10.2	52.1
NORIB	1.000	4	1.053	7.5	59.7
LNORIB	1.000	5	1.011	7.2	66.9
PLSINV	1.000	6	0.854	6.1	73.0
DHOME	1.000	7	0.727	5.2	78.2
PRSAV	1.000	8	0.638	4.6	82.8
ISLM	1.000	9	0.622	4.4	87.2
PARK	1.000	10	0.512	3.7	90.9
PTRP	1.000	11	0.445	3.2	94.1
TYPLON	1.000	12	0.381	2.7	96.8
LOAN	1.000	13	0.308	2.2	99.0
BRCH	1.000	14	0.139	1.0	100.0

KEY:

ENFR-encouragement of relatives & friends	PUBLIC- bank opening publicity
DWRK- distance from work	NORIB- no interest on savings
LNORIB- no interest on loans	PLSINV-profit-sharing investments
DHOME- distance from home	PRSAV- profits paid on savings
ISLM-runs on Islamic principles	PARK-parking facilities available
PTRP-public transport convenience	TYPLON-types of loans offered
LOAN-opportunity to get loan	BRCH-number of branches available

As noted earlier the number of factors to be extracted can be determined by the *eigenvalues*. Based on what is known as Kaiser's criterion²⁸² only factors having *eigenvalues* greater than 1 are considered significant and should be included in factor analysis.²⁸³ Following Kaiser's criterion the *eigenvalues* in Table 9.12 indicate that five factors can be extracted from the set of 14 variables. These five factors will explain 66.9 per cent of the total variance. However it is observed that the *eigenvalue* of the fifth factor is very close to 1 and perhaps is better excluded.

- Guideline 2: The Graphical Scree Test

The number of factors to be extracted can also be determined by running the graphical scree test procedure as proposed by Catell (1966). The scree plot (see Figure 9.1) is a graph which shows in descending order the variance accounted by the factors initially extracted. According to Catell only factors which lie above the point where the *eigenvalues* seem to gradually trail off should be retained. As can be seen in Figure 9.1, the graph begins to trail off after the third factor which indicates that the fourteen variables can be reduced to a set of three factors which will account for 52 per cent of the total variance.

- Guideline 3: Total Variance Explained

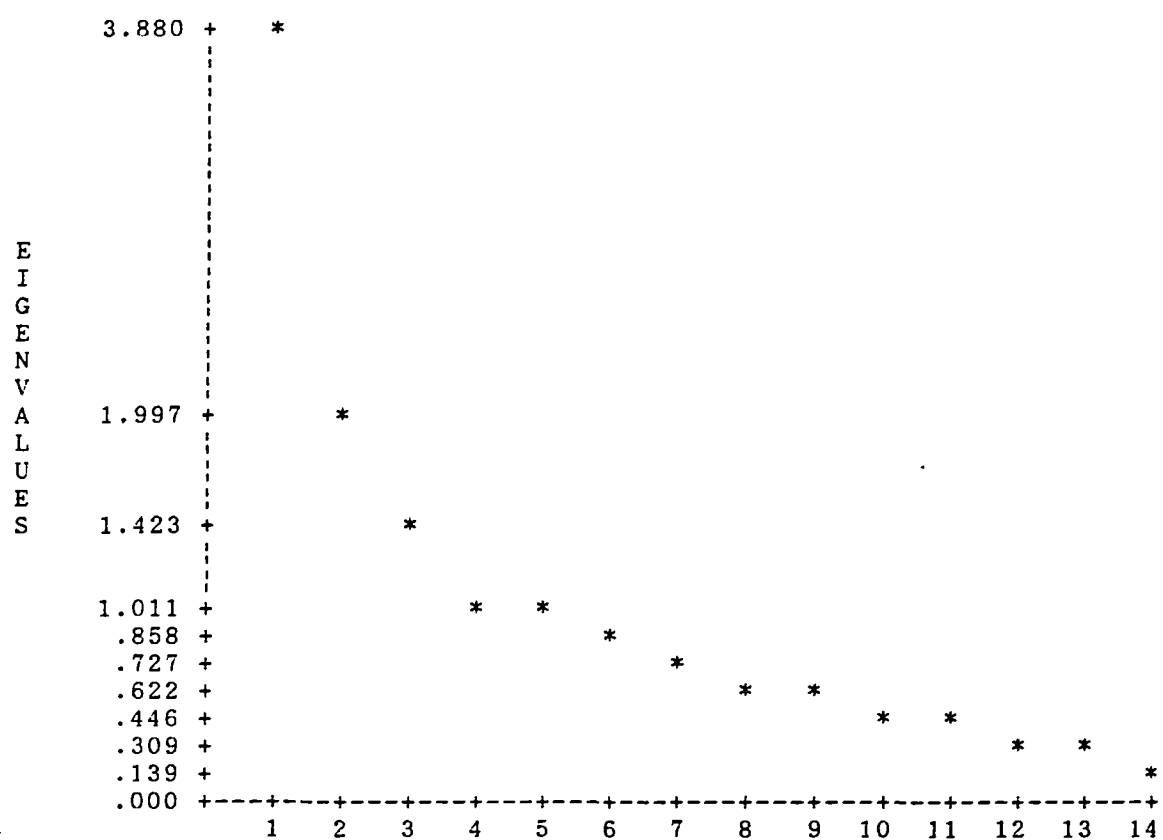
The results of the Kaiser criterion and the scree test suggest that a minimum of three and a maximum of five factors may be extracted from the fourteen variables. According to De Vaus²⁸⁴, a measure of a good factor analysis is the amount of total variance in the set of variables that is explained by the factors. The greater the

²⁸² Bryman:258.

²⁸³ Any factor having eigenvalue less than 1 is to be excluded because it explains less variance than a single variable since each variable has a variance of 1.

²⁸⁴ 1991:262.

**Figure 9.1 — Scree Plot- Eigenvalues of the 14 Factors Initially
Extracted**



explained variance the better the solution. However increasing the total variance explained would require an increase in the number of factors to be extracted which is not exactly in harmony with the aim of factor analysis. A tradeoff must therefore be made by minimizing the number of factors needed and maximizing the explained variance.

The most important figures to look next would be the cumulative percentages in Column 6. It is noticed that the extraction of four factors would explain only about 50 per cent of the total variance. Increasing the number to four factors would account for about 60 per cent whilst five factors will explain close to 67 per cent of the total variance. However the *eigenvalue* of the fifth factor shows a value close to 1 which signifies the possibility that only one variable may come under that factor. This is confirmed when an experimental run which extracted five factors showed that the fifth factor accounted only for a single variable which was incorporated into Factor 1 if only four factors were extracted. Based on this final result it is decided that the explained variance will be maximized and the number of factors will be minimized if four instead of five factors are extracted.

In summary, the initial extraction of factors as shown in Table 9.12 has enabled us to work out the number of factors needed for the final solution by looking at the *eigenvalues*, the scree plot and the total amount of variance accounted for, from which a trade off could be made between the desirable objectives of maximizing the total variance explained and minimizing the number of factors required.

The initial extraction of the four factors was then conducted and the output is shown in Table 9.13.

The final statistics showing the initial extraction of the four factors is exactly

similar to that in Table 9.12 except that the values of the communalities are now different since only four instead of fourteen factors have been extracted. As noted earlier the communalities measure the correlations among the 14 variables to be factor analysed. The higher the correlations among the variables; which implies the more they have in common the higher would be their communalities. For example a communality of 0.71024 for the ENFR variable indicates that the variable has 71 per cent of its variation in common with the other variables in forming a factor. On the other hand a variable having a very low communality (close to zero) is not likely to be associated with any other variables in defining a factor.²⁸⁵

Table 9.13 — Initial Extraction: Final Statistics (Principal Component Analysis)

VARIABLE		FACTOR			
Variable	Communality	Factor	Eigenvalue	% of variance	Cumulative %
ENFR	0.71024	1	3.880	27.7	27.7
PUBLIC	0.58552	2	1.997	14.3	42.0
DWRK	0.47420	3	1.422	10.2	52.1
NORIB	0.59953	4	1.053	7.5	59.7
LNORIB	0.62398				
PLSINV	0.62806				
DHOME	0.58647				
PRSAV	0.59277				
ISLM	0.27868				
PARK	0.63834				
PTRP	0.55544				
TYPLON	0.82694				
LOAN	0.84738				
BRCH	0.40635				

²⁸⁵ Jaeger 1990:351.

KEY:

ENFR-encouragement of relatives & friends	PUBLIC- bank opening publicity
DWRK- distance from work	NORIB- no interest on savings
LNORIB- no interest on loans	PLSINV-profit-sharing investments
DHOME- distance from home	PRSAV- profits paid on savings
ISLM-runs on Islamic principles	PARK-parking facilities available
PTRP-public transport convenience	TYPLON-types of loans offered
LOAN-opportunity to get loan	BRCH-number of branches available

9.3.3 STEP 3: Extraction of Final Factors by Rotation

The objective of this procedure is to group the variables having large loadings (correlations) for the same factors so that each factor will be represented by a unique and specific cluster of variables. This is done by the varimax orthogonal rotation which will ensure that the factors produced will be independent or unrelated to each other.²⁸⁶. First, variables which load (correlate) most highly with the first factor are clustered together and arranged in descending order according to the size of their correlations. Then variables which load strongly with the second factor will form the second factor, and so on.²⁸⁷

The product of the factor rotation is shown in Table 9.14. This rotated factor matrix is the crucial matrix to interpret the results of the factor analysis.

The interpretation of the four factors being extracted would be based on the the loadings of the fourteen variables on these factors. Each factor loading is the correlation coefficient which shows how much weight is assigned to that factor. Hence the factor loading of 0.71690 in the sixth row of the second column indicates the strength of the correlation between the variable DHOME and FACTOR 2.

²⁸⁶ The other method is oblique rotation which produces factors which are correlated. For a discussion of the various methods of rotating variables see Kim and Mueller 1978.

²⁸⁷ It is worth noting that orthogonal rotation has the disadvantage of forcing factors to be unrelated when they may be related in real life. Oblique rotation may be applied to check this.

Table 9.14 — Rotated Factor Matrix: Varimax Rotation

Variable No. & Code	FACTOR 1 Being an Islamic Bank	FACTOR 2 Convenient Location	FACTOR 3 Loan Opportunity	FACTOR 4 Social Influence	Communality of Each Variable
1. PRSAV	.75368				0.59277
2. NORIB	.75253				0.59953
3. PLSINV	.71271				0.62806
4. LNORIB	.59969		.51088		0.62398
5. ISLM	.44997				0.27868
6. DHOME		.71690			0.58647
7. PTRP		.69410			0.55544
8. DWRK		.65595			0.47420
9. PARK		.62942			0.63834
10. BRCH		.52159			0.40635
11. LOAN			.88200		0.81685
12. TYPLON			.87204		0.80372
13. ENFR				.82401	0.71024
14. PUBLIC				.66631	0.58522
Eigenvalue	3.88032	1.99714	1.42271	1.05374	
% of variance	27.7	14.3	10.2	7.5	
Cumulative %	27.7	42.0	52.1	59.7	

KEY:

ENFR-encouragement of relatives & friends PUBLIC- bank opening publicity
DWRK- distance from work NORIB- no interest on savings
LNORIB- no interest on loans PLSINV-profit-sharing investments
DHOME- distance from home PRSAV- profits paid on savings
ISLM-runs on Islamic principles PARK-parking facilities available
PTRP-public transport convenience TYPLON-types of loans offered
LOAN-opportunity to get loan BRCH-number of branches available

By looking at the variables which load most highly with a factor the researcher can therefore define a general label for that factor which is representative of the group of variables under it. Variables with factor loadings smaller than ± 0.3 are

normally considered not significant and can be ignored from the factor.²⁸⁸

Hence, based on the clustering of the variables as shown in Table 9.14 the four factors that have influenced depositors to select Bank Islam can be identified as follows:-

1. FACTOR 1: Being an Islamic Bank
2. FACTOR 2: Convenient Location
3. FACTOR 3: Loan Opportunity
4. FACTOR 4: Social Influence

9.3.4 FACTOR 1: Being an Islamic Bank

It is thought that 'Being an Islamic Bank' is the most appropriate description of FACTOR 1 because all the variables under this factor constitute elements which are unique only to the Islamic bank.

As shown in Table 9.14, FACTOR 1 is the linear combination of variables which differentiates the Islamic bank from the conventional bank; and can be expressed as;

$$\text{FACTOR 1} = f_{11}\text{PRSAV} + f_{12}\text{NORIB} + f_{13}\text{PLSINV} + f_{14}\text{LNORIB} + f_{15}\text{ISLM}....$$

(9.1)

²⁸⁸ Only factor loadings exceeding 0.4 are shown in Table 9.14 for easy interpretation of the results although the smaller values are included in the calculation of the variances.

where	factor loading
PRSAV= profits paid on savings	.75368
NORIB= no interest on savings	.75253
PLSINV= profit-sharing investment	.71271
LNORIB= no interest on loans	.59969
ISLM= runs on Islamic principles	.44997
f 's= factor score coefficient ¹	

Note: ¹ This score is the value of the factor which is calculated in STEP 4 of factor analysis. However STEP 4 is beyond the scope of this study. The relevance of equation 9.1 is to show the linear combinations of the variables.

The clustering of Variables 1 to 4 namely 'profits paid on savings' (PRSAV), 'no interest on savings' (NORIB), 'profit-sharing investment' (PLSINV) and 'no interest on loans' (LNORIB) portrays an underlying factor which emphasizes the uniqueness of the Islamic bank. The suitability of the factor label is further supported by the ISLM (runs on Islamic principles) variable which denotes in general terms the set of principles which underlies the overall Islamic characteristic of the Islamic bank.

Since FACTOR 1 has the highest eigenvalue and variance (eigenvalue=3.88, variance=27.7%) it necessarily represents the most important factor that has influenced depositors to bank with Bank Islam. In other words the Islamic characteristic of Bank Islam as represented by its overall Islamic operation, its interest-free savings account, the payment of profits instead of interest, its profit-sharing investment account and the availability of interest-free loans is the most important factor that has influenced depositors' preference for Bank Islam.

Obviously not all depositors would be homogeneously influenced by the five variables in FACTOR 1. Some might have been interested only in ensuring that their savings were free of interest oblivious of the return offered by the bank. Others might have quite happy to bank with Bank Islam as long as they knew that the bank operated on Islamic principles while a few might have opened an account just for the sake of securing a loan from Bank Islam. It is therefore worth examining the differences in depositors' behaviour in this respect.

Table 9.15 shows the extent to which depositors have been influenced by each of the FACTOR 1 variables in their selection decisions.

Table 9.15 — Frequency Distribution (%): Islamic Variables - Degree of Influence on Depositors' Preference for Bank Islam

Degree of Influence/ Value	ISLM (%)	PRSAV (%)	NORIB (%)	PLSINV (%)	LNORIB (%)
None 1	4.3	34.3	37.6	59.0	68.6
Little 2	1.4	7.6	6.7	6.2	8.5
Cumulative%	5.7	41.9	44.3	65.2	77.1
Quite Strong 3	10.0	11.4	8.1	4.3	4.8
Strong 4	44.8	32.4	30.0	19.0	9.5
Very Strong 5	39.5	14.3	17.6	11.5	8.6
Cumulative%	94.3	58.1	55.7	34.8	22.9
Median Value	4	3	3	1	1
Mode Value	4	1	1	1	1

Note: N=210. Since variables are ordinal, the median is the most appropriate measure of central tendency.

(i) Runs on Islamic principles

It is evident in Table 9.15 that a majority of depositors (94.3 per cent) have

been strongly influenced by the knowledge that the operation of Bank Islam was based on Islamic principles. This high response may be explained by the fact that an increasing number of Muslims in Malaysia have become more aware of their religion since the outbreak of the Islamic resurgence in the 1970s and the establishment of Bank Islam as an Islamic alternative to conventional banking provided a welcome opportunity for them to express their faith in the economic field. It is therefore important for Muslims to be assured that Bank Islam is run on Islamic principles to ensure that it is Islamically genuine and legitimate from the point of the *Shariah*.

(ii) No interest on Savings

Another important aspect of depositors' behaviour that can be derived from Table 9.15 is the relatively high importance attached to the savings account. This is indicated by depositors' ratings for the 'no interest on savings' (NORIB) and the 'profits paid on savings' (PRSAV) variables. About 58.1 per cent indicated that they were at least moderately influenced by the knowledge that savings would be free of interest at Bank Islam and 55.7 per cent were quite attracted by the fact that profits would be paid on savings.

It is worth noting, however, that the percentage of depositors not concerned by the nature of the savings account is almost proportional with those who were strongly influenced by it (34.3% : 32.4% and 37.6% : 30.0% respectively). Nevertheless the findings suggests that, **on the whole a majority of depositors were motivated by the religious incentive to free their savings from interest and by the monetary incentive in the form of profits paid on their savings.** As we have seen in Chapter VII, the savings account attracts the most

number of depositors and this finding may partly explain the reason behind it.

(iii) Profit-sharing Investment

In contrast to the savings account, the profit-sharing investment account did not seem to attract many depositors in general as indicated by the the values of the median and the mode (values=1 respectively). This result supports the fact shown in Chapter VII that the investment accounts attract fewer depositors. Only 34.8% were at least strongly attracted by the fact that the returns on investment deposits at Bank Islam would be based on profit-sharing; while the remaining 65.2% did not find it important.

Two plausible explanations may account for such behaviour. Firstly, the concept of profit-sharing on the basis of *mudarabah* on which the investment account operates is relatively new to many Malaysian Muslims. Unless one is involved in Islamic economics or Islamic studies, the term *mudarabah* is quite unknown to the ordinary man in the street. This opinion is supported by the following finding which shows that depositors were more familiar with the savings and current accounts compared with the profit-sharing investment account.

As shown in Table 9.16; 95.7 per cent (N=127) of depositors knew about the current account and 82.4 per cent (N=173) were aware of the savings account. In contrast, 60.5 per cent (N=127) have never heard about the investment account. Given this situation, it is not surprising that only about 30 per cent of depositors have been influenced by the investment account when selecting Bank Islam as their primary bank.

The second plausible reason for the unpopularity of the investment account among individual depositors may be attributed the minimum investment deposit

of M\$500 which is rather high even for the medium income earner. At the outset, Muslims in Malaysia generally save in small absolute amounts because of their low income levels. The more suitable investment outlets for such savings would be the Unit Trust Scheme (ASN) or the Tabung Haji. As described in Chapter V, an ASN investment can be made with as little as M\$10. Tabung Haji, on the other hand, accepts small amounts of deposits through various saving schemes and converts these savings into investments.

Table 9.16 — Frequency Distribution (N=210): Awareness of Deposit Accounts

Awareness/ Value	Current Account	Savings Account	Investment Account
Know 1	201 (95.7%)	173 (82.4%)	83 (39.5%)
Do not know 0	9 (4.3%)	37 (17.6%)	127 (60.5%)
Mode/Median	1	1	0

It is therefore envisaged that because of the high minimum deposit a majority of depositors who were highly influenced by the investment account would be those with high income. This hypothesis was tested by comparing if depositors in the various income groups differ with respect to their scores on the influence of the PLSINV variable on their decisions to bank with Bank Islam.

First it was noted that depositors can be divided into three income categories namely low, medium and high income. Since the Kruskal-Wallis Test is to be applied; the null hypothesis (H_0) and the alternative hypothesis (H_1) were stated as follows;

H_0 : the means of the PLSINV scores for the 3 income groups are equal.

H_1 : the means of the PLSINV scores for the 3 income groups are not equal.

Table 9.17 — Kruskal-Wallis Test Comparing the Mean Ranks (mean degree of influence) of PLSINV Between Income Groups (N=180)

Variable	Income Groups	Cases	Mean Rank
PLSINV	High	39	$k_1=108.97$
	Medium	74	$k_2= 89.55$
	Low	67	$k_3= 80.80$

Note:

High=M\$1401 and above

Medium=M\$701-M\$1400

Low=M\$700 and below

Chi-square value=9.2964 d.f=2 Significance=0.0096

The Kruskal-Wallis test shows that the mean degree of influence for the three income groups are not equal. It is also evident that the mean rank of the high income group ($k_1=108.97$) exceeds that of the low and medium income categories. This suggests that depositors with high income are more likely to be attracted by the investment account facility than those with medium or low income. The chi-square value=9.2964 is higher than the tabulated chi-square value=5.991 at 0.05 confidence level; 2 degrees of freedom.²⁸⁹ The null hypotheses that depositors in all income groups are equally influenced by the PLSINV variable can be rejected. The observed significance level ($P=0.0096$) is lower than the 0.05 confidence level which implies that the variations between the three groups are likely to hold in the population. It can therefore be inferred that **depositors with high income are**

²⁸⁹ the degree of freedom is $k - 1$ where k =number of samples or groups.

more likely to be influenced by the profit-sharing investment account offered by Bank Islam. In contrast to the ASN investment scheme which aims to pool the small investments of the Malays/Muslims, it seems that the Bank Islam investment account has been tailored for those in the high income category.

Our earlier findings (in Section 9.3) have shown that Muslims who bank exclusively with Bank Islam do not typically invest in the ASN. There may therefore be a need for the management of Bank Islam to consider devising other forms of 'affordable' investment schemes targeted on the the medium income earners who are still reluctant to participate in the ASN. Such schemes would provide some means for these Muslims to convert some of their savings into profitable investments.

(iv) Interest-free Loans

With regard to the influence of the LNORIB variable only 22.9 per cent were motivated by the interest-free loan facility when opening their accounts at Bank Islam. This small percentage implies that whilst most depositors were used to debt-financing as commonly practised by conventional banks, it is likely that many were still ignorant of the new concepts of Islamic financing introduced by Bank Islam and were therefore not influenced by them in the decision to bank with Bank Islam. In relation to this, the distribution of depositors who were aware of the Islamic methods of financing offered by Bank Islam was investigated.

As can be seen in Table 9.18 about 70 to 80 per cent of depositors (N=146-167) typically did not know most of the Islamic methods of financing available at Bank Islam. It seems that the terms and the concepts of partnership-profit-sharing (*Musharakah*), cost-plus and deferred payment sale (*Murabahah*, *Al-Bai*

Bithamin Aji), leasing (*Ijarah*) and interest-free loans (*Qardul Hasan*) are alien to these customers. The only better-known method is the trusteeship-profit-sharing or *Mudarabah*. About 41.9 per cent of depositors knew that this method of finance was available at Bank Islam.

Table 9.18 — Frequency Distribution (N=210): Awareness of Islamic Modes of Financing Offered by Bank Islam

Awareness/ Value	Mudarabah	Musharakah	Bai Bithamin Aji	Murabahah	Ijarah	Qardul Hasan
Know 1	88 (41.9%)	64 (30.5%)	63 (30.0%)	63 (30.0%)	43 (20.5%)	52 (24.8%)
Do not know 0	122 (58.1%)	146 (69.5%)	147 (70.0%)	147 (70.0%)	167 (79.5%)	158 (75.2%)
Mode/Median	0	0	0	0	0	0

Since a vast majority of depositors were ignorant of the concepts of Islamic financing introduced by Bank Islam, it is hypothesized that only those who received loans from Bank Islam would be highly influenced by the LNORIB variable. In relation to this the Mann-Whitney U-Test (hereafter the U-test) was carried out. The aim of the test is to see if depositors have the same mean scores for the LNORIB variable irrespective of whether they had a loan from Bank Islam or not. Since the U-test is a two-tailed test the null and alternative hypotheses are stated as follows:-

Let u_1 , and u_2 be the mean ranks (mean degree of influence) of the LNORIB variable for depositors who received and who did not receive loans from

Bank Islam respectively. Thus;

$$H_0 : u_1 = u_2 \quad H_1 : u_1 \neq u_2$$

Table 9.19 — Mann-Whitney U-Test To Compare the Mean Ranks of LNORIB Between Depositors Who Received and Did Not Receive Loans

Variable	GET LOAN ?	Cases	Mean Rank
LNORIB	Yes	21 (10%)	$u_1 = 130.02$
	No	189 (90%)	$u_2 = 102.78$

$$U \text{ value} = 1469.5 \quad z = -2.3744 \quad \text{Significance (2-tailed)} = 0.0177$$

Table 9.19 shows that the mean ranks of the LNORIB variable are not equal between the two groups of depositors. The mean rank of depositors who received loans from Bank Islam ($u_1 = 130.02$) is higher which indicate that this group of depositors is more influenced by the interest-free loan package in their bank selection decision compared to the other depositors. The z score for the sample ($z = -2.3744$) is higher than the tabulated $z_{0.025} = 1.96$. The null hypothesis of equal mean ranks for the LNORIB variable can be rejected. The observed 2-tailed probability ($P = 0.017$) is also smaller than the 0.025 level of significance which implies that the U-test results are likely to hold in the population. It can therefore be inferred that **only those who received loans from Bank Islam are most likely to be influenced by the interest-free loan facility when choosing Bank Islam as their primary bank.**

In summary it can be concluded that;

- Depositors select Bank Islam as their primary Bank mainly because it is an Islamic Bank which operates on Islamic principles and provides an Islamic alternative for Muslims to institutionalize their savings without interest as well as earn profits.
- With the exception of those with high income, individual depositors are typically not attracted by the profit-sharing investment account. Depositors are also generally not influenced by the interest-free loans available at Bank Islam.

9.3.5 FACTOR 2: Convenient Location

This is the second important factor that has attracted depositors to Bank Islam. As shown earlier in Table 9.14, FACTOR 2 accounts for 14.3 per cent of the total variance and together with Factor 1 explains about 42 per cent of the total variance.

Factor 2 is the linear combination of five variables which, as expressed in equation 9.2, are all related to the issue of easy access and locational convenience.

$$\text{FACTOR 2} = f_{21}\text{DHOME} + f_{22}\text{PTRP} + f_{23}\text{DWRK} + f_{24}\text{PARK} + f_{25}\text{BRCH}.... (9.2)$$

where	factor loading
DHOME= distance from home	.71690
PTRP= near to public transport facilities	.69410
DWRK= distance from work	.65595
PARK= availability of parking spaces	.62942
BRCH= number of branches available	.52159
<i>f</i> 's= factor score coefficient	

All five variables are moderately correlated with FACTOR 2 with factor loadings ranging between 0.521 to 0.716. The variables 'distance from home' (DHOME), 'distance from work' (DWRK) and 'the number of branches available' (BRCH) seem to indicate that locational convenience associated with Bank Islam was also taken into consideration by depositors in selecting Bank Islam as their primary bank. The fact that depositors were also influenced by the availability of parking spaces (PARK) and public transport convenience (PTRP) suggests that Bank Islam should also be easily accessible.

Table 9.20 shows the extent to which depositors were influenced by the convenient location variables when opening their accounts at Bank Islam.

Table 9.20 — Frequency Distribution (N=120): Convenient Location Variables-Degree of Influence

Degree of Influence/ Value		PTRP	DWRK	BRCH	PARK	DHOME
		(%)	(%)	(%)	(%)	(%)
None	1	43.3	53.8	50.0	61.4	55.2
Little	2	11.0	7.1	17.1	8.1	14.3
Cumulative%	-	54.3	60.9	67.1	69.5	69.5
Quite Strong	3	12.9	10.5	15.2	10.5	11.0
Strong	4	26.2	20.0	14.8	16.2	16.2
Very Strong	5	6.6	8.6	2.9	3.8	3.3
Cumulative%	-	45.7	39.1	32.9	30.5	30.5
Median Value		2	1	1.5	1	1
Mode Value		1	1	1	1	1

Given that depositors were mainly attracted to Bank Islam because of its Islamic characteristic it was expected that most depositors would not be highly

influenced by locational convenience. This is confirmed by the low values of the median and mode in Table 9.20. It is evident that except for the easy accessibility of the bank by public transportation, the other convenience variables were considered important only by about 31 to 39 per cent of the depositors.

(i) Public Transport Convenience

This is the most important convenience variable though it was considered important by less than half (45.7%) of total depositors. This finding tends to suggest that these depositors would be willing to bank with Bank Islam even though the bank may not be near to their home or place of work on condition that it is easily accessible by public transport. As we have seen earlier in Chapter VIII (Figure 8.2) the Jalan Raja Laut branch was indeed conveniently located between two main traffic arteries which were well-served by buses from various destinations around the city.

(ii) Parking Available

It is also interesting to note that depositors who place importance on public transport convenience also consider the parking facilities as important. As shown in Table 8.21 the Spearman Correlation Coefficient (ρ) shows a strong positive relationship ($\rho=0.533$) between the PTRP and PARK variables. This may suggest that depositors who own cars do not always drive to the bank but use the public transport. The observed significance level (0.000) indicates that this association is very likely to hold in the population. One possible explanation could be that it is sometimes more economical to use public transport because a short visit to the bank is not commensurate with the high charge for parking.

Table 9.21 — Spearman Correlation Between Parking and Public Transport Convenience (N=210)

	PTRP	Observed Significance
PARK	$\rho=0.533$	0.000

(iii) Distance from Work

Studies on bank selection decisions, for example by Kaufman (1969) and Bowers (1969) have shown that the convenient location of banks from both home and workplace were considered most important by households when selecting their primary banks. This study, however shows that the above finding does not hold for the depositors of the Islamic bank because of the religious motivation. In fact as shown by the values of the mode and the median in Table 9.20 the Islamic bank depositors were typically not influenced by the distance of the bank from where they worked.

The following null hypothesis was however tested to find out which depositors have been influenced by this variable.

- H_0 : Depositors are equally influenced by the distance of the bank from their workplace.

The crosstabulation in Table 9.22 shows that depositors are not equally influenced by the distance of Bank Islam from where they worked. About 61 per cent (N=128) of depositors were not concerned by this variable, of whom 73.4 per cent (N=94) worked in places located more than 2 miles from the bank. On the other hand 41.4 per cent of depositors (N=87) worked within the radius of 2 miles from

the bank and a majority of them (60.9 %, N=53) have been influenced by the close proximity of the bank from their workplaces.

**Table 9.22 — Crosstabulation: Influence of Distance From Work BY
Distance From Work in Miles.**

Distance from Work -	Distance From Work		Row Total
Degree of Influence	0-2 miles	more than 2 miles	
No-little influence	34	94	128 (61.0%)
Row %	(26.6%)	(73.4%)	
Column %	39.1%	76.4%	
Moderate-Very strong	53	29	82 (39.0)
Row %	(64.6%)	(35.4%)	
Column %	60.9%	23.6	
Column Total	87	123	210
	41.4%	58.6%	100.0%

Chi-square value=29.85 D.F = 1 Significance = 0.000

Since the computed chi-square value, 29.85 is greater than the tabulated chi-square value (3.841) at the 0.05 confidence limit at 1 degrees of freedom we can reject the null hypothesis that depositors are equally influenced by the distance of Bank Islam from their places of work. The above results suggest that **only depositors who work near to the bank tend to be more influenced by the distance of the bank from work. However a majority of Bank Islam depositors work in places located more than two miles from the bank and but not discouraged by the distance because of the stronger religious motivation.**

(iv) Distance From Home

It is also hypothesized that only a minority of depositors; specifically those who live near the bank would be more influenced by the distance of the bank from their homes. The following null hypothesis was then tested.

- H_0 : Depositors are equally influenced by the distance of Bank Islam from their homes.

Our results are shown in Table 9.23.

Table 9.23 — Crosstabulation: Influence of Distance From Home BY Distance From Home in Miles.

DHOME	Far	From Home	Row Total
Degree of Influence	0-2 miles	more than 2 miles	
No-little influence	12	134	146 (69.5%)
Row %	(8.2%)	(91.8%)	
Column %	48.0%	72.4%	
Moderate-Very strong	13	51	64 (30.5)
Row %	(20.3%)	(79.7%)	
Column %	52.0%	27.6%	
Column Total	25	185	210
	11.9%	88.1%	100.0%

Chi-square value=6.204 D.F = 1 Significance = 0.01274

Table 9.23 shows that depositors are not equally influenced by the distance of Bank Islam from their homes. A vast majority of depositors (N=185, 88.1%) live more than two miles from the bank and of these 91.8 per cent (N=134) were not affected by the distance of the bank from their homes. It is found that only

11.9 per cent of depositors (N=25) live within 2 miles from Bank Islam and more than half of them (N=13, 52.0%) have been at least moderately influenced by the proximity of the bank from where they live.

The chi-square value= 6.204 is higher than the tabulated chi-square (3.841) at the 0.05 confidence level at 1 degrees of freedom. The null hypothesis can therefore be rejected. The observed significance level is also lower than the 0.05 confidence level which implies that the result is likely to hold in the population. It can therefore be inferred that **only a minority of Bank Islam depositors are most likely to be influenced by the distance of the bank from their home. It is also evident that this involves only those who live near the bank whilst the vast majority of depositors live away from the bank and are not influenced by such factor.**

In terms of the relative influence between the distance from work and the distance from home, it was noticed earlier in Table 9.20 that the proportion of depositors influenced by the former was higher (39.1%) than the latter (30.5%). This tendency is probably due to the fact that 82.8 per cent (N=174) of depositors in the sample were gainfully employed and since the the bank business hours were restricted between 10.00 a.m and 3 p.m during the weekdays and 9.30 a.m and 11.30 a.m on Saturdays it is most likely that most depositors would tend to visit the bank from work rather than from home.

Interest-free Banking or Convenience?

The next question that arises is whether depositors who are influenced by the convenience variables are more likely to forgo Islamic banking for the sake of convenience. The hypothetical question relating to depositors' next bank choice

was again put to the test but this time using the Mann-Whitney nonparametric test to compare the mean ranks of the convenient location variables between the loyal and less loyal depositors.

Table 9.24 — Mann-Whitney U-Test To Compare the Mean Ranks of the Convenient Location Variables Between Loyal and the Less Loyal Depositors.

Variable	Next Bank Choice	Mean Rank	U value	z value	Probability(2-tailed)
DHOME	Bank Islam Nearest bank	$u_1 = 98.60$ $u_2 = 120.90$	3711.5	-2.710	0.006 *
PTRP	Bank Islam Nearest bank	$u_3 = 100.09$ $u_4 = 117.58$	3927.5	-2.036	0.0417*
DWRK	Bank Islam Nearest bank	$u_5 = 98.20$ $u_6 = 121.78$	3654.0	-2.847	0.004 *
PARK	Bank Islam Other bank	$u_7 = 101.18$ $u_8 = 115.13$	4086.5	-1.761	0.0782
BRCH	Bank Islam Other bank	$u_9 = 101.73$ $u_{10} = 113.92$	4165	-1.446	0.1481

Note: N=210

Bank Islam (in another area)=145 cases.

Nearest bank=65 cases.

* = significant.

The U-test results in Table 9.24 show that depositors who were less loyal to Bank Islam have relatively higher mean ranks ($u_2, u_4, u_6, u_8, u_{10}$) which implies

that these depositors were more influenced by the five convenience variables compared to the other group of depositors who preferred Bank Islam as their next bank choice. However the null hypotheses of equal mean ranks can only be rejected for the first three variables in Table 9.24 (namely DHOME, PTRP and DWRK) because only the z scores for these variables are higher than the decision rule value of $z_{0.025} = 1.96$. It is also evident that the results of the U-test for the PARK and BRCH variables are not likely to hold in the population because their observed probabilities (0.078, 0.1481 respectively) are higher than the 0.05 confidence level.

The above results suggest that **only depositors who attached high importance to the distance of Bank Islam from work or home and its accessibility by the public transport are likely to forgo banking with Bank Islam for the sake of convenience.** This would involve only a minority of depositors as indicated in the earlier analyses.

9.3.6 FACTOR 3: Loan Opportunity

This factor is labeled in accordance with the LOAN variable which has a very high factor loading of 0.8820. In fact TYPLON, the only other variable²⁹⁰ is also strongly correlated (factor loading= 0.87204) with FACTOR 3.

Hence FACTOR 3 may be expressed as the linear combinations of the two variables as follows:-

$$\text{FACTOR 3} = f_{31}\text{LOAN} + f_{32}\text{TYPLON} \dots (9.3)$$

²⁹⁰ The LNORIB variable can be ignored since it correlates better with FACTOR 1.

where factor loading

LOAN= opportunity to get loan .88200

TYPLON=types of loans offered .87204

f 's= factor score coefficient

Since FACTOR 3 is the third important factor as indicated by its eigenvalue it explains 10.2 per cent of the total variance. It is also expected that the proportion of depositors influenced by this factor would be relatively small. This is confirmed by the figures in Table 9.25.

Table 9.25 — Frequency Distribution: FACTOR 3 Variables - Degree of Influence on Depositors' Preference for Bank Islam

Degree of Influence/ Value	LOAN (%)	TYPLON (%)
None 1	63.3	61.4
Little 2	9.0	7.6
Cumulative% -	72.3	69.0
Quite Strong 3	9.0	10.0
Strong 4	15.7	17.6
Very Strong 5	2.9	3.3
Cumulative% -	27.6	30.9
Median Value	1	1
Mode Value	1	1

Only 27.6 per cent of depositors were at least moderately influenced by the opportunity to get loans from Bank Islam. 63.3 per cent were not influenced at all. Similarly 30.9 per cent were attracted by the types of loans offered by Bank Islam.

It is hypothesized that depositors who rated highly for FACTOR 3 would be those who have managed to secure loans from Bank Islam. The U-test results as shown in Table 9.26 seem to support this expectation.

Table 9.26 — Mann-Whitney U-Test of Association between FACTOR 3 Variables and GET LOAN ?

Variable	GET LOAN ?	Mean Rank	U value	z value	Probability(2-tailed)
LOAN	Yes	$u_1 = 140.62$	1247.0	-3.2440	0.0012
	No	$u_2 = 101.60$			
TYPLON	Yes	$u_3 = 140.83$	1242.5	-3.2192	0.0013
	No	$u_4 = 101.57$			

Note:

Yes= 21 cases (10%)

No=189 cases (90%)

It is evident that depositors who received loans from Bank Islam have higher mean scores for the LOAN and TYPLON variables which indicate that they are more influenced by both variables than the other depositors. The z values are -3.2440 and -3.2192 respectively which are higher than the critical value of $z_{0.025}=1.96$. The null hypotheses that $u_1=u_2$ and $u_3=u_4$ are rejected. These variations in mean ranks are also likely to hold in the population since the observed probabilities (0.0012 and 0.0013 respectively) are lower than the 0.05 confidence interval. It can be inferred that **only depositors who received loans from Bank Islam had been strongly influenced by Factor 3 when selecting the Bank as their primary bank.**

9.3.7 FACTOR 4: Social Influence

As we have seen earlier in Table 9.14, FACTOR 4 is the linear combinations of two variables representing social influence as shown in equation 9.4.

$$\text{FACTOR 4} = f_{41}\text{ENFR} + f_{42}\text{PUBLIC} \dots (9.4)$$

where	factor loading
ENFR= encouragement of relatives and friends	.71024
PUBLIC= bank opening publicity	.58522
f 's= factor score coefficient	

Social influence has often emerged as one of the common factors in studies on bank selection decisions. For example studies by Anderson and Cox (1976) and Tan (1981) have found that 'recommendation by friends' was ranked more influential than 'locational convenience'. Whilst these findings apply to the depositors of conventional banks our findings show that **social influence plays a less important role in determining the bank selection decisions of Islamic bank depositors**. The results of the factor analysis ranked social influence as the fourth important factor and compared with other variables it explains only 7.5 per cent of the total variance for the variables in the data set.

As can be seen in Table 9.27, only 31.9 per cent depositors have been at least moderately influenced by their relatives or friends to bank at Bank Islam. On the other hand, almost three-quarters (74.8%) seems to have selected Bank Islam on the basis of their personal preferences.

About 50 per cent of depositors have been influenced by the opening publicity of Bank Islam in 1983. One would expect that the first depositors of Bank Islam would tend to have been more influenced by such publicity compared with

subsequent depositors.

Table 9.27 — Frequency Distribution (N=210): Social Influence - Degree of Influence on Depositors' Preference for Bank Islam

Degree of Influence/ Value		ENFR (%)	PUBLIC (%)
None	1	57.1	38.1
Little	2	11.0	11.9
Cumulative%	-	74.8	50.0
Quite Strong	3	15.2	12.4
Strong	4	14.8	31.9
Very Strong	5	1.9	5.7
Cumulative%	-	31.9	50.0
Median Value		1	2.5
Mode Value		1	1

Table 9.28 — Kruskal-Wallis Test To Compare the Mean Ranks of the Bank Opening Publicity Variable Between First and Non-First Depositors.

Variable	When was account opened?	Number of Cases	Mean Rank
PUBLIC	1983	47	$k_1 = 132.07$
	1984-1985	45	$k_2 = 109.29$
	1986-1988	53	$k_3 = 101.75$
	1989-1991	65	$k_4 = 86.72$

chi-square value=17.1413 d.f=3 Significance=0.0007

Table 9.28 shows the results of the Kruskal-Wallis test which compares the mean ranks k_1 , k_2 , k_3 and k_4 between the first depositors who opened their account in 1983 and subsequent depositors in the following years.

It is evident that the mean ranks between the four groups are not equal. It is also noticed that the mean rank for first depositors who opened their accounts in 1983 exceeds that of the other depositors. The value of the chi-square=17.1413 is higher than the tabulated chi-square value= 7.815 at the 0.05 significance level and 3 degrees of freedom. The null hypothesis that $k_1=k_2=k_3=k_4$ is rejected. Since the observed significance (0.0007) is higher than the 0.05 confidence interval the variations in mean ranks are likely to hold in the population. It can therefore be deduced that **the influence of the bank opening publicity is greatest amongst first depositors compared to subsequent depositors.**

In conclusion Muslims in the urban areas are attracted to Bank Islam mainly because it offers an Islamic alternative which is fundamentally different from the traditional bank in terms of its operation and the types of services offered. The influence of contextual factors such as locational convenience and easy accessibility are second in importance whilst social influence plays a less important role in determining depositors' preference for Bank Islam as their primary bank. These findings show that an Islamic bank operating side by side with a relatively developed conventional banking system can still create its own niche in the market for pious Muslims who are committed in avoiding *riba*. The bank selection decisions of these Muslims are fundamentally different from the typical conventional bank customer who places high importance to locational convenience;²⁹¹ or social

²⁹¹ as shown in the studies by Kaufman (1969) and Bowers (1969).

influence²⁹². For the religious Muslim the motivation to avoid *riba* surpasses all other factors in their bank selection decision. An important question that arises however is whether Islamic banking can go beyond this captive group of depositors and penetrate further into the market especially in attracting other Muslims who currently bank only with the interest-based banks.

9.4 Analysis of Muslim Depositors of Riba Banks

Whilst the analysis in the preceding sections was confined to the depositors of Bank Islam, the subject of interest in this section will be Muslims who do not bank with Bank Islam but have accounts in the interest-based banks. This group of Muslims forms a segment of the market which is still uncaptured by Islamic banking. It seems that the religious factor is not a sufficient motivation for them to open an account at Bank Islam. In this section an attempt will be made to examine the perceptions of this group of Muslims on the question of *riba*. Their reasons for not banking with Bank Islam and the factors which have influenced them to bank only with the interest-based banks will also be identified. This information will provide an insight on how this group of Muslims differ from the depositors of Bank Islam and how they may be attracted to Islamic banking in future.

9.4.1 Perception of Riba and Interest

One of the possible reasons why this group of Muslims continue banking with the conventional banks even after the establishment of Bank Islam may be their ignorance of the Islamic rule on *riba* and its modern connotations. It is possible that some of these Muslims may have never heard of the word *riba* before. On

²⁹² as reported by Anderson and Cox (1976).

the other hand, those who know about the Islamic prohibition of *riba* may not exactly know what *riba* is. This problem is further complicated by the controversy between *riba* and interest.

The following null hypothesis was tested to find out if Muslims who banked with the interest-based banks were really ignorant of *riba*.

1. H_0 : Muslims who bank with the Islamic bank or the interest-based banks are equally aware of the word *riba*.

**Table 9.29 — Crosstabulation: Heard of Riba By Respective Banks
Depositors**

Have you heard of <i>riba</i> before?	Depositors		Row Total
	Bank Islam	Conventional Bank	
Yes	209	168	377(99.2%)
Column %	99.5%	98.8%	
No	1	2	3(0.8)
Row %	.5%	1.2%	
Column Total	210	170	380
	55.3 %	44.7%	100%

Chi-square value= .58821 D.F = 1 Significance = 0.44311

Table 9.29 shows that almost 100 per cent (99.5%, N=209) of Bank Islam depositors have heard of *riba* before and close to 99 per cent (98.8%, N=168) of the conventional bank depositors were also aware of *riba*. The close margin suggests that Muslims who bank with the interest-based banks were not ignorant of the word *riba*. In fact our results show that this group of depositors are as equally aware of *riba* as the depositors of Bank Islam. This is confirmed by the

computed chi-square value (.58821) which is lower than the tabulated chi-square value (3.841), at 0.05 significance level, at one degree of freedom; which necessarily means that the null hypothesis cannot be rejected. It can therefore be inferred that **like the depositors of Bank Islam, Muslims who bank with the interest-based banks are not ignorant of *riba***. This general awareness may be seen as one of the direct effects of the Islamic resurgence on the Malaysian Muslims. As noted earlier in Chapter VI, the prohibition of *riba* was one of the central issues being raised by the Islamic opposition party, PAS, in their propagation for the establishment of an Islamic State. The prohibition of *riba* was also emphasized by the Muslim youth organizations in calling Muslims to adopt Islam as a complete way of life. These organizations have indeed been instrumental in creating an awareness among Muslims on the Islamic injunction against *riba*. As indicated by our finding the prohibition of *riba* has become common knowledge to the ordinary Muslim. What constitutes *riba* is of course another question.

In order to find out depositors' understanding of the true concept of *riba* that is prohibited in Islam, the following null hypothesis was tested.

2. H_0 : Muslims who bank with the Islamic bank or the interest-based banks are equally agreed that interest is the same as *riba*.

Only the opinion of depositors who were aware of *riba* is taken into account in Table 9.30. It is evident that close to 70 per cent of Bank Islam depositors (68.9%, N=144) perceived that interest was the same as *riba*; 18 per cent thought that interest was not *riba* while 12.9 per cent were unsure. On the other hand, less than half of the conventional bank depositors (45.2%, N=76) knew that interest was indeed *riba*. The rest of them were either unsure (32.7%, N=55) or did not

agree (22.0%, N=37) that both interest and *riba* were prohibited in Islam. These results imply that Muslims who bank with the Islamic bank are typically aware of the similarity between *riba* and interest. In contrast a high proportion of Muslim depositors of the interest-based banks do not have a clear understanding of the true concept of *riba* that is prohibited by their religion.

**Table 9.30 — Crosstabulation: Opinion on Riba & Interest By
Respective Banks' Depositors...(controlling for Have you heard of
riba?= Yes)**

Is interest the same as <i>riba</i> ?	Bank Islam Depositors	Conventional Bank Depositors	Row Total
Yes	144*	76 *	220(58.4%)
Column %	68.9%	45.2%	
No	38	37	75(19.9%)
Column %	18.2%	22.0%	
Unsure	27	55*	82(21.8%)
Column %	12.9%	32.9%	
Column Total	209	168	377
	55.4 %	44.6%	100%

Chi-square value=26.446 D.F = 2 Significance = 0.00000

This difference in perception between both groups of Muslims are likely to hold in the population. As shown by the chi-square statistics the null hypothesis can be rejected. This is because the computed chi-square value (26.446) is greater than the tabulated chi-square value (5.991) at the 0.05 confidence limit at 2 degrees of freedom. The null hypothesis that Muslim depositors of Bank Islam and the conventional banks equally agree that interest is the the same as *riba* can therefore

be rejected. The difference of opinion is likely to hold in the population since the observed significance level ($P=0.000$) is lower than the 0.05 confidence interval.

We can therefore conclude that **even though Muslims who bank entirely with the interest-based banks know that *riba* is forbidden in Islam they generally do not have a clear understanding of the true concept of *riba* that is prohibited by their religion. Their willingness to continue banking with the interest-based banks may be partly explained by this ignorance.**

The attitude of these Muslims towards interest and *riba* may also be explained by their willingness to invest in the ASN. As shown in Table 9.31 more than 70 per cent (71.2%, $N=126$) of these Muslims held ASN shares compared to the relatively lower percentage of Bank Islam depositors (40%, $N=84$) who did not participate in the scheme.

Table 9.31 — Crosstabulation: Invest in ASN By The Respective Bank Depositors

Do you invest in the ASN?	Baank Islam Depositors	Conventional Bank Depositors	Row Total Total
Yes	84	121*	205(53.9%)
Column %	40.0%	71.2%	
No	126*	49	175(46.1%)
Column %	60.0%	28.8%	
Column Total	210	170	380
	55.3 %	44.7%	100%

Chi-square value= 36.75 D.F = 1 Significance = 0.00000

The computed chi-square value (36.75) is higher than the tabulated value (3.841) at the 0.05 level of significance; at one degree of freedom. The null hypothesis is therefore rejected. Since the observed significance level ($P=0.000$) is lower than the 0.05 confidence level it can be inferred that Muslims who bank with the interest-based banks are more likely to invest in the Amanah Saham Nasional compared with the Muslim depositors of Bank Islam.

We can therefore conclude that the Muslim depositors of the interest-based banks lacked the religious motivation to bank with the Islamic bank because of their perception that interest was not the same as *riba*. Because of this ignorance they are less committed in avoiding *riba* compared with their Bank Islam counterpart.

9.4.2 Reasons For Not Banking With Bank Islam

On the assumption that Muslims who bank exclusively with the interest-based banks are relatively less committed in avoiding *riba* the relevant question that arises is whether these depositors were not motivated to bank with the Islamic bank because of the lower rates of returns on deposits offered by the bank. During the survey, these depositors were asked to indicate three main reasons for not banking with Bank Islam. The frequencies of their responses are summarized in Table 9.32.

The list of factors in Table 9.32 shows that the rate of return was the least important factor that had discouraged these depositors from banking with the Islamic bank. Only two depositors indicated to have been disappointed by the lower rates of returns on the savings offered by Bank Islam. Other depositors (43.9%) were generally discouraged by the fact that ATMs were unavailable and that there

were too few Bank Islam branches. This finding suggests that this group of Muslims preferred the conventional bank over Bank Islam for the same reasons that a majority of Bank Islam depositors maintained their accounts with the conventional banks. The rate of return factor is not important to both groups. Instead they were more concerned with the ATM service and the number of branches which the Islamic bank still lacks.

Table 9.32 — Frequency Distribution: Reason for Not Saving in Bank Islam

Why do you not have an account at Bank Islam?	Frequency	Percent	Cumulative Percent
1. No ATM	119	23.3	23.3
2. Too few branches	105	20.6	43.9
3. Don't know what services are available	85	16.6	60.5
4. Salary paid here	71	13.9	74.4
5. Expensive loans	23	4.6	79.0
6. Not interested	22	4.3	83.3
7. Slow & Inefficient	16	3.1	86.4
8. Lower returns on savings	2	0.4	86.8
9. Others	30	5.9	92.7
(gives only 2 reasons)	37	7.3	100
Total	510*	100.0	

Note: * refers to response not cases since each respondent was asked to give three main reasons (i.e $170 \times 3 = 510$)

The preceding result seems to imply that in the absence of the religious motivation, the bank selection decisions of Muslims who bank entirely with the conventional banks may not be different from the typical conventional bank depositors

who view convenience as a key determinant of bank patronage. Previous research, for example by Foster (1968), Kaufman (1969), Bowers (1969) and Bennett (1972) in the United States has shown that location is the most important bank selection criterion. On the other hand, other studies have found that social influence²⁹³ and financial considerations²⁹⁴ rather than convenience are the main determinants of bank patronage. Which of these factors are important to Muslims who bank with the interest-based banks will be further investigated. Our objective in the following section is to ascertain the main factors that have influenced Muslims to bank entirely with the interest-based banks with the view that such knowledge may provide some insight on how a fully-fledged Islamic bank such as Bank Islam may increase its market share of deposits in the competitive urban market.

9.5 Bank Selection Criteria (Riba Banks' Depositors)

9.5.1 Factor Analysis

As in the previous analysis of Bank Islam depositors the bank selection determinants of the interest-based bank depositors will be identified by factor analysis. There are fifteen variables to be analysed. However before a smaller set of underlying factors can be derived from these variables it is necessary to assess whether factor analysis can be applied to the data set.

A correlation matrix as in Table 9.33 was first run to obtain the KMO measure of sampling adequacy and the Bartlett Test of sphericity. The statistics for the Bartlett test is recorded at 800.17 with zero level of observed significance which indicates that the correlation matrix is not an identity matrix and is therefore

²⁹³ Anderson & Cox 1976.

²⁹⁴ Chua 1989.

Table 9.33 — Correlation Matrix-DEMPLY to WLKNWN

	DEMPLY	ENCFR	ADVERT	DWRK	DHOME	DSHOP	PARK
DEMPLY	1.00000						
ENCFR	.02875	1.00000					
ADVERT	.03839	.39711	1.00000				
DWRK	-.16968	-.04547	.07662	1.00000			
DHOME	.01819	.23702	.28179	.20067	1.00000		
DSHOP	.06274	.29519	.29374	.19285	.44770	1.00000	
PARK	.04364	.16888	.31746	.08076	.24423	.46417	1.00000
PTRP	.00703	.22412	.25109	.14497	.29243	.54390	.56865
FASTSV	-.07088	.19831	.26704	.10295	.31840	.31316	.38769
ATM	-.15500	.10016	.17162	.35063	.28255	.28494	.19597
RSAB	.04768	.19822	.33741	.10079	.30954	.37790	.36983
LOAN	.04138	.12858	.37577	-.09716	.18871	.21993	.29549
TYPLOAN	.03433	.08353	.34979	-.04529	.11488	.22018	.33919
BRCH	-.16745	.10599	.18490	.23046	.31590	.31603	.28127
WLKNWN	-.02719	.14794	.25720	.18670	.26250	.35973	.32105
	PTRP	FASTSV	ATM	RSAB	LOAN	TYPLOAN	BRCH
PTRP	1.00000						
FASTSV	.34512	1.00000					
ATM	.29589	.39845	1.00000				
RSAB	.37386	.35411	.21892	1.00000			
LOAN	.23445	.22188	.15922	.48968	1.00000		
TYPLOAN	.21923	.23478	.15798	.44377	.71949	1.00000	
BRCH	.21576	.44192	.46291	.22480	.17600	.21439	1.00000
WLKNWN	.35255	.43012	.34393	.31469	.25053	.29517	.68452
WLKNWN							
WLKNWN	1.00000						

KAISER-MEYER-OLKIN MEASURE OF SAMPLING ADEQUACY = .81039

BARTLETT TEST OF SPHERICITY = 800.17117, SIGNIFICANCE = .00000

suitable for factor analysis. The KMO statistic on the other hand yields a value at 0.810. This high value suggests that the correlations are on the whole sufficiently strong for factor analysis to be carried out. Following the above procedure, it is then necessary to determine the number of factors that can be extracted from the list of 15 variables. Since this number can be ascertained by the *eigenvalues*, 15 factors are initially extracted²⁹⁵ to see the *eigenvalues* for all the factors and the percentage of variance explained by each of them.

The initial extraction of the fifteen factors is shown in Table 9.34

Table 9.34 — Initial Extraction:Initial Statistics
(Principal-Components Analysis)

VARIABLE		FACTOR			
Variable	Communality	Factor	Eigenvalue	% of variance	Cumulative %
DEMPLOY	1.000	1	4.695*	31.3	31.3
ENCFR	1.000	2	1.801*	12.0	43.3
ADVERT	1.000	3	1.316*	8.8	52.1
DWRK	1.000	4	1.029*	6.9	59.0
DHOME	1.000	5	0.956	6.4	65.3
DSHOP	1.000	6	0.881	5.9	71.2
PARK	1.000	7	0.715	4.8	76.0
PTRP	1.000	8	0.671	4.5	80.5
FASTSV	1.000	9	0.597	4.0	84.4
ATM	1.000	10	0.573	3.8	88.3
RSAY	1.000	11	0.444	3.0	91.2
LOAN	1.000	12	0.408	2.7	94.0
TYPLON	1.000	13	0.400	2.7	96.6
BRCH	1.000	14	0.263	1.8	98.4
WLKNWN	1.000	15	0.243	1.6	100.0

²⁹⁵ the number of factors initially extracted is equal to the number of variables in the set.

KEY:

DEMPY-salary paid in this bank	DSHOP-distance from where I shop
ENCFR-encouragement of relatives/friends	ADVERT- advertisements
DWRK- distance from work	DHOME- distance from home
PARK-parking facilities available	PTRP-public transport convenience
FASTSV-fast counter service	ATM-autoteller machines available
RSAB-rate of interest on savings	LOAN-opportunity to get loans
TYPLON-types of loans offered	BRCH-number of branches available
WLKNWN-wellknown bank	

The importance of the *eigenvalues*, as we have seen in the previous analysis of Bank Islam depositors, is associated with the Kaiser criterion which allows only factors having *eigenvalues* greater than 1 to be significant enough to be factor analysed.

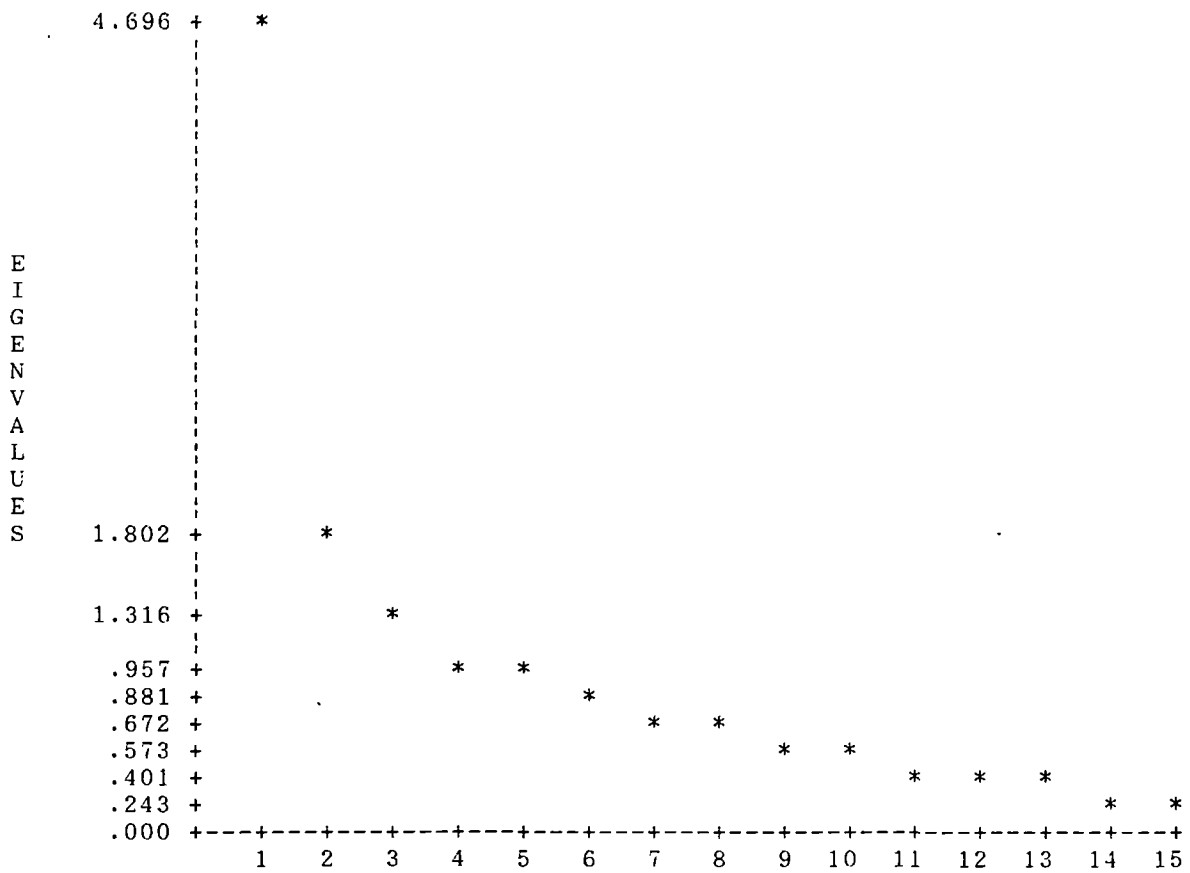
Looking at the *eigenvalues* in Table 9.34 it is noticed that four factors have *eigenvalues* greater than 1, ranging from 4.695 for the first factor and 1.029 for the fourth factor. Thus in accordance to the Kaiser criterion four factors should be extracted in this analysis. All four factors will explain 59 per cent of the variance.

The graphical scree-test also denotes a similar number of factors to be extracted. As shown in Figure 9.2 the scree-plot begins to level off after the fourth factor which is indicative that only the four factors above the scree should be factor analysed.

Based on the Kaiser criterion and the graphical scree-test it is apparent that the fifteen variables can be reduced to a smaller set of four factors to represent the bank selection criteria of the Muslim depositors of the interest-based banks.

The initial extraction of the four factors is shown in Table 9.35. Because the initial extraction of factors did not show which variables belong most clearly to which factors the varimax orthogonal rotation was carried out so that each

Figure 9.2 — Scree Plot- Eigenvalues of the 15 Factors Initially
Extracted



factor would be represented by a unique cluster of variables. The rotated factor matrix as shown in Table 9.36 provides a clear picture of the four factors and its accompanying variables.

Table 9.35 — Initial Extraction: Final Statistics (Principal Component Analysis)

VARIABLE		FACTOR			
Variable	Communality	Factor	Eigenvalue	% of variance	Cumulative %
DEMPLY	.38863	1	4.695	31.3	31.3
ENCFR	.76263	1	1.801	1.801	43.3
ADVERT	.61561	2	1.316	12.0	52.1
DWRK	.39935	3	1.029	8.8	59.0
DHOME	.44304	4			
DSHOP	.65279	5			
PARK	.61665	6			
PTRP	.66655	7			
FASTSV	.44919	8			
ATM	.53082	9			
RSAB	.51404	10			
LOAN	.78837	11			
TYPLON	.78875	12			
BRCH	.66885	13			
WLKNWN	.55821	14			

KEY:

DEMPLY-salary paid in this bank	DSHOP-distance from where I shop
ENCFR-encouragement of relatives/friends	ADVERT- advertisements
DWRK- distance from work	DHOME- distance from home
PARK-parking facilities available	PTRP-public transport convenience
FASTSV-fast counter service	ATM-autoteller machines available
RSAB-rate of interest on savings	LOAN-opportunity to get loans
TYPLON-types of loans offered	BRCH-number of branches available
WLKNWN-wellknown bank	

Table 9.36 — Rotated Factor Matrix: Varimax Rotation

Variable No. & Code	FACTOR 1 Convenience	FACTOR 2 Easy Accessibility	FACTOR 3 Financial Services Available	FACTOR 4 Social Influence
1. BRCH	.77907			
2. ATM	.70021			
3. WLKNWN	.61993			
4. DWRK	.55849			
5. FASTSV	.50219			
6. DEMPLY	-			
7. PTRP		.78028		
8. DSHOP		.71517		
9. PARK		.71426		
10. TYPLON			.87575	
11. LOAN			.87138	
12. RSAV			.54213	
13. ENCFR				.88646
14. ADVERT				.66274
15. DHOME				-
Eigenvalue	4.69568	1.80169	1.31622	1.02990
% of variance	31.3	12.0	8.8	6.9
Cumulative %	31.3	43.3	52.1	59.0

KEY:

DEMPLOY-salary paid in this bank	DSHOP-distance from where I shop
ENCFR-encouragement of relatives/friends	ADVERT- advertisements
DWRK- distance from work	DHOME- distance from home
PARK-parking facilities available	PTRP-public transport convenience
FASTSV-fast counter service	ATM-autoteller machines available
RSAB-rate of interest on savings	LOAN-opportunity to get loans
TYPLON-types of loans offered	BRCH-number of branches available
WLKNWN-wellknown bank	

The variable groupings in the rotated factor matrix seem to suggest that Muslims who prefer to bank entirely with the interest-based banks do so because of the following four factors:-

- FACTOR 1: Convenience
- FACTOR 2: Easy Accessibility
- FACTOR 3: Financial Services Available
- FACTOR 4: Social Influence.

The clustering of the variables and their respective loadings under the four factors indicate that ‘convenience’ is the key determinant which distinguishes the bank selection decision of Muslim depositors of the interest-based banks and the Islamic bank. Whilst both groups were relatively unaffected by social influence²⁹⁶ and were less concerned with the rates of return and the types of loans offered by their respective banks, it is clear that various aspects of convenience as represented by Factor 1 as well as Factor 2 were of primary importance to Muslims who bank exclusively with the interest-based banks.

9.5.2 FACTOR 1: Convenience

The importance of convenience as the main bank selection determinant for the Muslim depositors of the interest-based banks is denoted by the fact that this factor has the highest *eigenvalue* and explains 31.3 per cent of the total variance. As shown by Equation 9.5, Factor 1 is the linear combinations of five variables representing convenience as follows;

$$\text{FACTOR 1} = f_{11}\text{BRCH} + f_{12}\text{WLKNWN} + f_{13}\text{ATM} + f_{14}\text{DWRK} + f_{15}\text{FASTSV} \dots (9.5)$$

²⁹⁶ Social influence was also ranked fourth in the bank selection criteria of the Bank Islam depositors.

where	factor loadings
BRCH= number of branches	.77907
ATM= autoteller machines available	.70021
WLKNWN= wellknown bank	.61993
DWRK= distance from work	.55849
FASTSV= fast counter-service	.50219
f 's= factor score coefficient	

All five variables are moderately correlated with FACTOR 1 with factor loadings ranging between 0.502 to 0.779. The variables 'many branches' (BRCH) and 'distance from work' (DWRK) indicate the importance of the locational convenience of the interest-based banks to these depositors. The 'availability of autoteller machines' (ATM) and 'fast counter service' denotes, on the other hand, the importance of transactional convenience to the depositors. The 'well-known bank' variable may also be indirectly associated with convenience in the wider sense. The relatively strong weight of this variable in Factor 1 may be attributed to depositors' great concern for the safety of their deposits. In the light of the scandals of the deposit-taking cooperatives and the collapse of a few commercial banks during the recession it is plausible that depositors consider it important and convenient to deposit their money in banks which are well-known and have a good business reputation. The label 'convenience' is therefore justified to represent the variables in FACTOR 1 in the broad sense.

The extent to which depositors have been influenced by each of the convenience variable under FACTOR 1 is depicted in Table 9.37.

It is evident from the frequency distribution in Table 9.37 that a very high

proportion of Muslims who bank entirely with the interest-based banks are **highly convenience-oriented**. The measures of central tendency (median=4, mode=4) indicate that, these Muslims were typically strongly motivated by the numerous bank branches (BRCH), the distance of the bank from work (DWRK) and the availability of electronic banking through the auto-teller machines (ATM). The speed of services being offered at the bank counters (FASTSV) was relatively less important as indicated by the values of the median and the mode (respective values=3).

Table 9.37 — Frequency Distribution (N=170): FACTOR 1 Variables - Degree of Influence on Depositors' Preference for Interest-Based Banks

Degree of Influence/ Value		BRCH	DWRK	ATM	FASTSV	WLKNWN
		(%)	(%)	(%)	(%)	(%)
None	1	9.4	11.2	14.7	15.9	18.8
Little	2	6.5	6.4	5.3	10.6	4.7
Cumulative%	-	15.9	17.6	20.0	26.5	23.5
Quite Strong	3	11.2	11.2	7.1	37.6	16.5
Strong	4	51.8	41.8	54.1	28.8	43.5
Very Strong	5	21.1	29.4	18.8	7.1	16.5
Cumulative%	-	84.1	82.4	80.0	73.5	76.5
Median Value		4	4	4	3	4
Mode Value		4	4	4	3	4

The strong influence of convenience on the bank selection decisions of these Muslims is in contrast with its impact on the depositors of Bank Islam. As shown earlier in Table 9.20 the latter were relatively not influenced by convenience in their decision to bank with Bank Islam. Except for the accessibility of Bank Islam by public transportation which was considered important by 45 per cent of the

Islamic bank depositors more than 60 per cent of them were not influenced by the other dimensions of convenience.

(a) Locational Convenience

It is evident in Table 9.37 that the greatest motivation for Muslims to bank with the interest-based banks is locational convenience in terms of the numerous branches and the close proximity of these banks to the depositors' workplaces. More than 80 per cent of depositors have been at least moderately influenced by both variables (84.1% and 82.4% respectively).

Our findings also show that there are no significant differences between the influence of the BRCH variable on different subgroups of the sample.

Table 9.38 — Kruskal-Wallis Test Comparing the Mean Ranks of BRCH in terms of Age, Income and Occupation

Variable	Subgroup	Cases	Mean Rank	Significance
BRCH: Many Branches	AGE: ¹ (in years)			0.1133 ⁺
	18-25	41 (24.1%)	$k_1 = 72.65$	
	26-40	111 (65.3%)	$k_2 = 89.80$	
	41 and over	18 (10.6%)	$k_3 = 88.28$	
	INCOME: ² (M\$)			0.2128 ⁺
	700 & below	59 (36.6%)	$k_4 = 73.26$	
	701-1400	53 (32.9%)	$k_5 = 84.10$	
	1401 and above	49 (30.5%)	$k_6 = 86.96$	
	OCCUPATION: ³			0.0994 ⁺
	Professional/ Administration: ⁴	85 (53.1%)	$k_7 = 85.20$	
	Clerical	47 (29.4%)	$k_8 = 69.17$	
	Unskilled & Others	28 (17.5%)	$k_9 = 85.25$	

Note: ¹ N=170, ² N=161, ³ N=160, ⁴ includes technicians and executives, ⁺ not significant.

As shown by the Kruskal-Wallis Test results in Table 9.38 even though there are differences in the mean ranks of various subgroups in terms of their age, income and occupation these differences are not likely to hold in the population since the observed significance levels are higher than the 0.05 confidence limit.

The null hypothesis of equal independent means can therefore be accepted; which suggests that urban Muslims who bank entirely with the interest-based banks are **homogenously influenced (in this case strongly influenced) by the extensive branch network of the conventional banks in their bank selection decisions.**

On the other hand, our results on the impact of the DWRK variable show that the Muslim depositors of the conventional bank were not homogeneously influenced by the locational convenience of the interest-based banks from their workplaces. It is found that certain groups of depositors are likely to be more influenced than others by this factor in their bank selection decisions.

The Kruskal-Wallis Test and U-Test results in Table 9.39 show that the following groups of depositors are more likely to have been strongly influenced by the convenient location of the interest-based banks from their work places.

As can be seen in Table 9.39 the demographic profile of a depositor who is strongly influenced by locational convenience of the interest-based banks from his/her place of work is rather distinct: age between 26-40, working within 2 miles from the bank, with college or university education and tend to work as professionals, technician or executives earning above average income. These inferences are made on the basis that the null hypothesis of equal mean ranks for the DWRK variable between depositors in terms of their age, education, income, occupation

and the distance of their workplaces from their banks can be rejected respectively.

Table 9.39 — K-W and U-Test results Comparing the Mean Ranks of DWRK in terms of Age, Distance from Work, Education, Income and Occupation

Variable	Subgroup	Cases	Mean Rank	z, χ^2	Significance
Distance From Work	AGE: (in years)		K-W TEST:		
	18-25	41 (24.1%)	$k_1 = 71.21$	$\chi^2=18.6$	0.0002
	26-40	111 (65.3%)	$k_2 = 96.13^*$		
	41 and over	18 (10.6%)	$k_3 = 52.50$		
	FAR FROM WORK (in miles):		K-W TEST:		
	0-2	135 (79.4%)	$k_4 = 93.61^*$	$\chi^2=23.83$	0.0000
	3-5	15 (8.8%)	$k_5 = 54.07$		
	more than 5	20 (11.8%)	$k_6 = 54.33$		
	EDUCATION:		U-TEST:		
	secondary or lower	85 (50.0%)	$u_1 = 77.88$	$z=-2.1303$	0.0331
	college or university	85 (50.0%)	$u_2 = 93.12^*$		
	INCOME: ¹ (M\$)				
	700 & below	59 (36.6%)	$k_7 = 67.59$	$\chi^2=8.8691$	0.0119
	701-1400	53 (32.9%)	$k_8 = 86.66$		
	1401 and above	49 (30.5%)	$k_9 = 91.02^*$		
	OCCUPATION: ²				
	Professional ³	85 (53.1%)	$k_{10} = 87.73^*$	$\chi^2=7.7406$	0.0209
	Clerical	47 (29.4%)	$k_{11} = 78.82$		
	Unskilled & Others	28 (17.5%)	$k_{12} = 61.38$		

Note: ¹ N=161, ² N=160, ³ includes technicians & executives

The computed chisquare values of the K-W tests are higher than the tabulated chisquare value ($\chi^2=5.991$), at 2 degrees of freedom. Similarly, the computed z value ($z=-2.1303$) is higher than the $z_{0.05}=1.96$ critical value. These statistics imply that the null hypothesis of equal means can be rejected. These differences

are also likely to hold in the population since all the observed significance levels are lower than the 0.05 confidence level. We can therefore infer that Muslim depositors who are strongly influenced by the locational convenience of the interest-based banks from their workplaces are likely to be between 26-40 years old, working within 2 miles from the bank, with college or university education and tend to work as professionals, technician or executives earning above average income.

Whilst the age and place of work of the depositor are rather self-evident in the sense that only depositors who are of working age²⁹⁷ and work near the banks will be necessarily more influenced by the DWRK variable, it is interesting to note that the more affluent depositors tend to be more influenced by this variable compared with the lower income or the lower educated depositors. This tendency seems to suggest that depositors with higher socio-economic status are the most convenience-oriented within the group. They regard banking as a convenience good and it is an important criteria for a bank to be conveniently located near their workplaces.

(b) Transactional Convenience

Besides locational convenience, the influence of 'transactional convenience' is also significant among Muslims who bank entirely with the interest-based banks. This is indicated by the high ratings given to the ATM and FASTSV (fast counter service) variables. Eighty per cent of the sampled population (as seen earlier in Table 9.37) were at least moderately influenced by the availability of ATMs and 73.5 per cent by the fast counter services. It is also noted that more than half (54%) have been strongly motivated to bank with the interest-based bank because of the ATM.

²⁹⁷ The working age in Malaysia is defined between 18-60 years old

Whilst depositors are generally homogeneous in rating the influence of the ATM in their bank selection decisions, two distinct characteristics of depositors who were most influenced by the availability of the ATM in their bank selection decision can be identified. Firstly, our findings show that this facility has a greater impact on the younger rather than the older depositors.

The Kruskal-Wallis Test results in Table 9.40, shows that depositors between the ages of 18 and 25 years old have the highest mean rank ($k_1 = 92.35$) for the ATM variable; followed by the majority who were 26 to 40 years old with mean rank $k_2 = 87.97$. The lowest mean rank (k_3) is recorded by those over forty years old. As the chisquare value ($\chi^2 = 9.8076$) is higher than the tabulated chisquare statistic ($\chi^2 = 5.991$) at two degrees of freedom we can reject the null hypothesis of equal sample means at the 0.05 critical point.

Table 9.40 — Kruskal-Wallis Test Comparing the Mean Ranks (mean degree of influence) of ATM in terms of Age

Variable	Subgroup	Cases	Mean Rank	Significance
ATM	Age (in years)			
	18-25	41 (24.1%)	$k_1 = 92.35^*$	0.0074 $\chi^2 = 9.8076$
	26-40	111 (65.3%)	$k_2 = 87.97$	
	41 and over	18 (10.6%)	$k_3 = 52.50$	

We can therefore conclude that **the younger rather than the older urban Muslims are more likely to be most influenced by the availability of the ATM in their decision to bank primarily with the interest-based banks.** A plausible explanation for this tendency is that younger people are more adaptable to change compared with the older generation who tend to be more

conservative and preferred to do their banking by the traditional way.

It is also found that the influence of the ATM is greatest amongst the convenience-oriented professional and semi-professionals compared with depositors in the other professions. The availability of the ATM seems relatively less important to depositors in the administrative services and its importance continues to decrease as one moves down the occupational ladder.

Table 9.41 — Kruskal-Wallis Test Comparing the Mean Ranks (mean degree of influence) of ATM in terms of Occupation

Variable	Subgroup	Cases	Mean Rank	Significance
ATM	Occupation ²			
	Professional ³	40 (53.1%)	$k_4 = 96.59^*$	
	Administration ⁴	45 (29.4%)	$k_5 = 78.81$	0.0326
	Clerical	47 (29.4%)	$k_6 = 75.50$	$\chi^2=8.7622$
	Unskilled & Others	28 (17.5%)	$k_7 = 68.63$	

Note: ² N=160, ³ includes technicians, ⁴ includes executives.

As can be seen in Table 9.41 the mean rank of the professionals is the highest where $k_4=96.59$. The mean rank of the administrators and executive is very much lower where $k_5=78.81$ while depositors in the clerical pool scored 75.50. These differences are likely to hold in the population since the chisquare value ($\chi^2=8.7622$) which is higher than the tabulated $\chi^2=7.815$ at 3 degrees of freedom which allows us to reject the null hypothesis of equal sample means at the 0.05 confidence level.

We can therefore deduce that the impact of the ATM in attracting urban Muslims to the interest-based banks is greatest among the young depositors and the the high-income earners in particular the professionals

and semi-professionals. This finding is in close agreement with the results of an earlier comparative study of the ATM and non-ATM users in Malaysia²⁹⁸; which showed that active ATM users in Malaysia tend to be “highly educated, aged between 25-34 years with above average income”. It was also reported in the study that unlike the inactive cardholder, the active ATM users tend to ‘rely less on the traditional ways of conducting financial transaction’ through the bank counters. Assuming that Muslim depositors who were strongly influenced by the ATM would also constitute the active ATM users it is likely that they would conduct their banking transactions less frequently through the bank counters.

In relation to this it is hypothesized that depositors who attach more importance to the ATM would be moderately influenced by the fast counter service and the reverse is likely to apply to depositors who prefer to carry out their transactions through the bank counters.

The Spearman Rank Correlation between the ATM and FASTSV variables seems to support this hypothesis.

Table 9.42 — Spearman Correlation Between ATM and Fast Counter Service

	ATM
FASTSV	$\rho=0.3127$
Significance	0.000
Note:	N=170

As shown in Table 9.42 there is a positive correlation between ATM and

²⁹⁸ reported by Oliver Ho (1987:7).

FASTSV. The correlation coefficient ($\rho=0.3127$) however shows a moderate relationship which suggests that depositors who are influenced by the ATM are also influenced by the fast-counter service but at a lesser degree; and vice-versa. The observed significance level ($P=0.000$) indicates that the relationship is likely to hold in the population at the 0.05 level of statistical significance.

We are now able to identify that depositors who attached high importance on the availability of the ATMs and the proximity of their banks from where they work are of high net worth. These depositors tend to work as professionals or semi-professionals, with high education and above average income and belong to the 26-40 working age group.

Because a majority of these depositors have been strongly influenced by the BRCH, DWRK and ATM variables under FACTOR 1 it is envisaged that their decision to bank primarily with the interest-based bank is based on the combination of the three factors simultaneously. Hence in the context of Bank Islam, even though the Bank Islam branch in this study is conveniently located in the same area as the interest-based banks our findings have shown that a majority of depositors who bank with the interest-based banks were working in locations very near to both banks.

The following null hypothesis was tested to examine if any relationship exist between the DWRK, ATM and BRCH variables.

- H_0 : Depositors who are influenced by the convenient location of the conventional banks in their bank selection decision are equally not influenced by the ATM and the availability of many interest-based bank branches.

**Table 9.43 — Crosstabulation: ATM By BRCH ...Controlling for
DWRK= Influenced (N=140)**

ATM	BRCH		Row Total
	Not Influenced	Influenced	
Not Influenced	8	12	20(14.3%)
Total %	5.7%	8.6%	
Influenced	9	111*	120(85.7)
Total %	6.4%	79.3%	
Column Total	17	123	140
	12.1 %	87.9%	100%

Chi-square value=16.97 D.F = 1 Significance = 0.0004

The crosstabulation in Table 9.43 shows the relationship between the influence of the ATM and the BRCH variables amongst depositors who were influenced by the distance of the interest-based banks from their place of work (DWRK). It is evident that out of 140 depositors who were influenced by the convenient location of the bank from their workplaces, 79.3 per cent (N=111) were also influenced by the availability of the ATM in their bank selection decisions. On the other hand only 5.7 per cent (N=8) were not influenced at all by the ATM and BRCH variables. The chisquare value (16.97) is higher than the critical chisquare value (3.841) at one degree of freedom. The null hypothesis of no association between the ATM, BRCH and DWRK variables can be rejected at the 0.05 level of statistical significance. It can therefore be inferred that even though the Islamic bank may be conveniently located as the interest-based banks, the convenience-oriented Muslim depositors would still prefer the interest-based banks because the availability of the ATMs and the extensive branch network provided by the interest-based banks were also important to them. In other words, **the Muslim depositors of the interest-**

based banks are attracted to these banks because of the combination of locational and transactional convenience as well as the convenience of branch-banking which the Islamic bank still lacks.

9.5.3 FACTOR 2: Easy Accessibility

$$\text{FACTOR 2} = f_{21}\text{PTRP} + f_{22}\text{DSHOP} + f_{23}\text{PARK} \dots (9.6)$$

where	factor loadings
PTRP= public transport convenience	.78028
DSHOP= distance from shopping centre	.71517
PARK= availability of parking facility	.71426
f 's= factor score coefficient	

As shown in Equation 9.6 FACTOR 2 can be seen as an extension of FACTOR 1 because it represents another aspect of convenience which is related to the accessibility of the bank either by public or private transportation as well as its proximity to the shopping centres. Since the majority of depositors have been strongly influenced by the variables under FACTOR 1 it is expected that the impact of the variables under FACTOR 2 would affect a smaller percentage of depositors. This is confirmed by the frequency distribution in Table 9.44.

It is evident that public transport accessibility is the most important variable in FACTOR 2. Compared with the other two variables, about 61.2 per cent of depositors have been influenced to bank with the interest-based banks because of the convenience of public transport. Only 37 per cent have been strongly influenced by the convenient location from the shopping centre and 30 per cent by the availability of parking facilities.

Table 9.44 — Frequency Distribution (N=170): FACTOR 2 Variables - Degree of Influence on Depositors' Preference for Interest-Based Banks

Degree of Influence/ Value	PTRP (%)	DSHOP (%)	PARK (%)
None 1	32.9	32.4	41.2
Little 2	5.9	11.8	9.4
Cumulative%	38.8	44.2	50.6
Quite Strong 3	12.4	13.5	14.1
Strong 4	40.6	37.1	30.0
Very Strong 5	8.2	5.2	5.3
Cumulative%	61.2	55.8	49.4
Median Value	3	3	2
Mode Value	4	4	1

The nonparametric tests also show that depositors who have been most influenced by the public transport convenience are distinguishable in terms of their level of education, income and occupation.

It is evident from the results of the K-W and the U tests in Table 9.45 that depositors who were less educated, with low income of M\$700 or less and employed in the clerical or unskilled jobs had higher mean scores for the PTRP variable compared with their respective counterparts. The z value for the U-test ($z = -2.219$) and the chisquare values for the K-W tests ($\chi^2 = 8.564$ and $\chi^2 = 10.283$) are higher than their respective critical points at the 0.05 level of statistical significance.²⁹⁹ The null hypothesis of equal means can therefore be rejected which implies that the lower income and less educated depositors are more concerned with the easy accessibility of the interest-based banks by public transportation rather than locational or transactional convenience. The importance of public transport convenience to

²⁹⁹ The tabulated $z_{0.05} = 1.96$ and the $\chi^2_{0.05, 2 \text{ d.f.}} = 5.991$.

these small savers may serve as a useful criterion for selecting suitable locations for the establishment of minibranches in the lower income states.

Table 9.45 — Kruskal-Wallis Test & U-Test Comparing the Mean Ranks of PTRP in terms of Education, Income & Occupation

Variable	Subgroup	Cases	Mean Rank	Significance
Public	Education: ¹		U-Test:	
Transport	secondary or lower	85 (50.0%)	$u_1 = 93.42^*$	0.0265
Convenience	college or university	85 (50.0%)	$u_2 = 77.58$	$z = -2.219$
Public	Income: ² (M\$)		K-W Test:	
Transport	700 & below	59 (36.6%)	$k_3 = 88.31^*$	
Convenience	701-1400	53 (32.9%)	$k_4 = 87.01$	0.0138
	1401 and above	49 (30.5%)	$k_5 = 65.70$	$\chi^2 = 8.5649$
Public	Occupation: ³		K-W Test:	
Transport	Professional	40 (25.0%)	$k_6 = 62.0$	
Convenience	Administrator	45 (28.1%)	$k_7 = 81.10$	0.0163
	Clerical	47 (29.4%)	$k_8 = 86.65$	$\chi^2 = 0.0163$
	Unskilled & Others	28 (17.5%)	$k_9 = 94.39^*$	

Note: ¹ N=170, ² N=161, ³ N=160.

9.5.4 FACTOR 3: Financial Services Available

FACTOR 3 represents the influence of the financial services offered by the interest-based banks and is comprised of three variables as shown in equation 9.7.

$$\text{FACTOR 3} = f_{21}\text{TYPLON} + f_{22}\text{LOAN} + f_{23}\text{RSAV} \dots (9.7)$$

where	factor loadings
TYPLON = type of loans offered	.87575
LOAN = opportunity to get loans	.87138
RSAB= rate of return on savings	.54213
f 's= factor score coefficient	

Since it is the third important factor extracted from the data set, the influence of FACTOR 3 influence on the Muslim depositors' decision to bank with the interest-based banks is expected to be relatively less significant.

The values of the median and the mode of the frequency distribution in Table 9.46 show that Muslim depositors of the interest-based banks were generally not influenced by the types of loans, the rate of return on savings or the opportunity to secure loans in their decision to bank primarily with the interest-based banks. More than half (51.2%) of these Muslim depositors were not influenced at all by the types of loans offered by the interest-based banks. Similarly 55.3 per cent were not concerned at all with the opportunity to secure loans from these banks and only 39.4 per cent regarded the rate of return paid on their savings account as relatively important. A plausible explanation is that more than half of these depositors (54.7%, N=93) were public sector employees who were more likely to make use of the government housing loan facility rather than borrow from the interest-based banks. The current interest-rate charged by the government on such loan is 4 per cent per year compared with the rates charged by the conventional banks some of which exceed 10 per cent per annum. The above finding further support our earlier findings that individual Muslim depositors bank primarily with the interest-based banks because of the convenience provided rather than to earn interest.

Table 9.46 — Frequency Distribution (N=170): FACTOR 3 Variables - Degree of Influence on Depositors' Preference for Interest-Based Banks

Degree of Influence/ Value		TYPLON (%)	LOAN (%)	RSAV (%)
None	1	51.2	55.3	48.8
Little	2	6.5	8.8	11.8
Cumulative%	-	57.7	64.1	60.6
Quite Strong	3	23.5	20.0	28.2
Strong	4	15.3	13.5	10.6
Very Strong	5	3.5	2.4	0.6
Cumulative%	-	42.3	35.9	39.4
Median Value		1	1	2
Mode Value		1	1	1

This finding, however, differs from that of an earlier study by Chua (1989) which examined the bank selection decisions of Malaysian households of an urban residential area near Kuala Lumpur. The study, which was carried out on a sample consisting of 68 per cent non-Malays, revealed that 'financial services offered' by the conventional banks which included loans, overdrafts and the rate of interest on deposits were rated most important relative to convenience and social influence. The difference between our results and that of Chua indirectly shows that different marketing strategies may be applied to attract different groups of potential depositors to Islamic banking. Whilst promotional appeals emphasising on relative rates of profits on deposits may be the most effective approach to attract non-Muslims to Islamic banks the provision of convenience-banking may be quite sufficient to induce the less strict Muslims to shift their funds from the conventional commercial banks to the Islamic bank.

9.5.5 FACTOR 4: Social Influence

Corresponding to our earlier findings on the bank selection criteria of Bank Islam depositors it is also found that social influence plays a less important role in the bank selection decision of the Muslim depositors of the interest-based banks. Social influence is ranked fourth in importance and represents the linear combination of two variables as shown in Equation 9.8.

$$\text{FACTOR 4} = f_{41}\text{ENCFR} + f_{42}\text{ADVERT} \dots (9.8)$$

where	factor loadings
ENCFR = encouragement of relatives/friends	.87575
ADVERT = advertisements	.87138
f 's = factor score coefficient	

Table 9.47 shows that less than 30 percent of depositors were socially influenced in selecting their present bank. About 28.9 per cent have been at least moderately motivated by the advertising promotion by the banks and a lesser proportion (21.2%) have been encouraged by their relatives or friends.

The nonparametric tests do not show any significant difference on the impact of the two social influence variables on the various subgroups. This suggests that **Muslims are generally not influenced by social influence in their decision to select the interest-based banks as their primary bank.** This finding is also in agreement with the findings of the study by Chua (1989) but contradicts that of Anderson and Cox (1976) which reported 'recommendation by friends' as more influential than locational convenience.

Table 9.47 — Frequency Distribution (N=170): FACTOR 4 Variables - Degree of Influence on Depositors' Preference for Interest-Based Banks

Degree of Influence/ Value	ENCFR (%)	ADVERT (%)
None 1	65.3	57.6
Little 2	13.5	13.5
Cumulative%	78.8	71.1
Quite Strong 3	8.8	17.1
Strong 4	11.2	10.6
Very Strong 5	1.2	1.2
Cumulative%	21.2	28.9
Median Value	1	1
Mode Value	1	1

From the analysis of the above four factors it can be concluded that;

1. The factors influencing the bank selection decisions of Muslim individuals who bank primarily with the interest-based banks are quite similar with that of the typical conventional bank depositors even though the importance attributed to some factors may differ between the two groups. The Muslim individuals were highly influenced by both locational and transactional convenience and to a lesser extent by the accessibility of public transport, the products and financial services offered and social influence.
2. The main attraction of the interest-based banks to their Muslim depositors is the combination of an extensive branch network, their convenient location from depositors' work places and the availability of the ATMs.
3. Depositors with high education, high income and professional positions tend to highly convenience-oriented and are strongly influenced by the convenience-oriented factors.

nient location of the interest-based banks from their place of work and the transactional convenience provided by the ATMs.

4. The impact of the ATM is greatest among the younger depositors which implies that the importance of the ATM will remain high as the current population ages.
5. The rates of return on deposits and the types of loans are relatively unimportant to most Muslim depositors of the conventional banks.
6. On the whole convenience is the prime reason why Muslim depositors bank primarily with the conventional banks.

9.5.6 Market Implications

9.5.6.1 Convenience Banking

Perhaps one of the most important market implications that emerges from the preceding analysis is the ability of Islamic banks to provide convenience-banking to the attract patronage from a wider section of the Muslim population. Whilst the religious motivation may be sufficient to sustain patronage from the existing depositors of Bank Islam we have identified that both locational convenience in the form of an extensive branch network and transactional convenience through the ATMs are important to Muslims who currently bank exclusively with the conventional banks. The present package of Islamic banking services offered by Bank Islam does not seem to fulfill the banking needs of these Muslims. Hence even though existing Bank Islam branches may be conveniently located in the same area as the interest-based banks the lack of the ATM and the limited number of branches puts Bank Islam at the disadvantage in the competition for deposits from

these convenience-oriented Muslims.

As a new player in the market Bank Islam is indeed very far behind in the competition for deposits through its branches. Its current branch network cannot match the convenience of branch banking that the four well-known top banks in Malaysia are providing to their depositors. The Central bank records³⁰⁰ show that there were 186 branches of the Malayan Banking Berhad (MBB) at the end of September 1988. The second largest bank Bank Bumiputra Berhad (BBMB) had 124 branches at the same date followed by Public Bank Berhad and the UMBC with 64 and 62 branches respectively. In comparison to the widespread branch network of these interest-based banks there were only 22 Bank Islam branch offices throughout the country at the end of June 1988 and the number rose only to 29 by 1991. For depositors who enjoy having their money within their easy reach almost anywhere throughout the country it seems that Bank Islam does not have much to offer in terms of branch banking.

In terms of the ATMs Bank Islam is one of the few banks which does not offer such services to its depositors. Even though the management has announced its intention to install the ATMs in mid-1992³⁰¹ the project is still in its planning stage. All the major banks in Malaysia are already providing this service with fierce competition for customers.³⁰² The establishment of shared ATM networks³⁰³ has also enabled smaller banks to participate in offering this service in the market. It is envisaged that the provision of the ATM service is essential for all banks in the urban

³⁰⁰ 'Money and Banking in Malaysia' Bank Negara Malaysia 30th Anniversary Edition 1989.

³⁰¹ *Berita Harian* 30 June 1991.

³⁰² To boost depositors' self-esteem and pride in owning an ATM card, the banks have promoted their own imaginative ATM card labels; the more well-known ones are the MBB's Kawanku (My Friend), BBMB's Juwara (Champion), Public Bank's PR Card and Kwong Yik Bank's Boss.

³⁰³ for example the Group Electronic Automated Teller Network or GREAT.

areas, including Islamic banks, since urban depositors are generally convenience-oriented and their loyalties are easily influenced by the type of convenient banking services that a bank could offer.³⁰⁴ Our findings have also shown that the demand for the ATMs is also high amongst the depositors of Bank Islam especially those who still hold accounts in the interest-based banks. It is envisaged that the introduction of the ATMs would not only attract the convenience-oriented Muslim depositors of the interest-based banks but is also likely to induce the Islamic bank depositors who hold accounts in the conventional banks to bank exclusively with the Islamic bank.

9.5.6.2 The Establishment of Islamic Counters

As Bank Islam is approaching the end of its ten year monopoly of Islamic banking in the Malaysian market in 1993, an Islamic Banking Sector has been opened at the Central Bank in June 1992 to deal with the imminent establishment of Islamic banking units by conventional banks. These units will be allowed to compete in offering Islamic financing by *murabahah* (cost-plus), *ijarah* (leasing), *al-Bai Bithamin Ajil* (instalment sale), export finance syndications and investment funds.³⁰⁵ The conventional banks are also allowed to open Islamic banking windows to accept deposits from the public under the supervision of the Central Bank.

In view of the impending competition for deposits between the Islamic and conventional banks an attempt is made in this study to gauge the response of Muslim depositors in both banking systems towards the introduction of such facility. Our results show that a majority of depositors were not opposed to the idea.

³⁰⁴ Ismail, Bashir "Banking World" May; 1987:37.

³⁰⁵ New Horizon Magazine, No.6 July 1992:16.

Table 9.48 — Crosstabulation: Opinion on the Introduction of Islamic Counters By Respective Banks' Depositors

Islamic Counters	Bank Islam	Conventional Bank	Row Total
at conventional banks?	Depositors	Depositors	
Agree	149	129	278(73.2%)
Column %	71.0%	75.9%	
Disagree	50	33	83(21.8%)
Column %	23.8%	19.4%	
No Opinion	11	8	19(5.0%)
Column %	5.2%	4.7%	
Column Total	210	170	380
	55.3 %	44.7%	100%

Chi-square value=1.19720 D.F = 2 Significance = 0.54958

It is evident in Table 9.48 that almost three quarters of total Muslim depositors sampled from both Bank Islam and the conventional banks welcomed the idea of Islamic counters. Only 21.8 per cent (N=83) did not agree to it and 5 per cent (N=19) expressed no opinion. It is noticed, however, that the proportion of conventional bank depositors who agreed was slightly higher than the Bank Islam depositors. Nevertheless, this difference is not likely to hold in the population. As can be seen in Table 9.48, the chisquare value ($\chi^2=1.197$) is lower than the $\chi^2_{0.05}=5.991$ at 2 degrees of freedom. The null hypothesis cannot be rejected which implies that both groups of depositors equally agree with the introduction of the Islamic counters.

**Table 9.49 — Crosstabulation: Conceived Benefits of Islamic Counters
By Respective Banks' Depositors**

Islamic Counters at conventional banks?	Bank Islam Depositors	Conventional Bank Depositors	Row Total
AGREE:			
Avoid <i>riba</i>	73	48	121(35.8%)
Column %	40.3%	30.6%	
Convenient	25	45	70(20.7%)
Column %	13.8%	28.7%	
More Competitive	31	30	61(18.0%)
Column %	17.1%	19.1%	
DISAGREE:			
Bank Not Totally Islamic	52	34	86(25.4%)
Column %	28.7%	21.7%	
Column Total	210	170	380
	55.3 %	44.7%	100%

Chi-square value=13.02494 D.F = 3 Significance = 0.00458

What benefits do these depositors perceive from these counters? Even though there seems to be a consensus on the introduction of the Islamic counters, both groups of depositors had different perceptions on the benefits that would emanate from such counters. As shown in Table 9.49 a majority of Bank Islam depositors (40.3%, N=73) anticipated the religious benefit in terms of the avoidance of *riba* as the prime benefit followed by convenience and competition which would improve the quality of consumer services. However almost an equal proportion (48% and 45%) of Muslim depositors of the conventional banks, considered the religious

advantage and convenience as important respectively. About 30.6 per cent foresee the opportunity to evade *riba* while another 28.7 per cent liked the idea without having to give up the convenience that they currently enjoy from the conventional banks.

Here again we see that convenience is considered relatively important by the conventional bank depositors compared with the depositors of Bank Islam.

9.5.7 Policy Implication

An important policy implication that emerges from the analysis of both groups of depositors is the need to educate the population about the principles of Islamic banking and the different types of services that can be offered by the Islamic bank. Since the present government aims to develop a dual banking system whereby the new Islamic banking system will complement the existing conventional banking structure it is only relevant that the awareness of the new system and a knowledge of Islamic methods of financing should be promoted via in the education system. It is a more effective way of explaining the complexity of the methods such as *mudarabah* and *musharakah* compared with advertisements which is effective to the extent that it only excites short-lived interest in the Islamic banking products that is being marketed.³⁰⁶

At present, Muslims are generally ignorant of the banking services that are available at Bank Islam. To a society which has only known debt-financing as the only method of borrowing from banks it is essential to educate them on the new concepts of profit-sharing, partnerships, deferred payment sale, leasing and markup sale. The lack of understanding of the bank's concepts and operations have

³⁰⁶ Wilson 1990:24.

led many to think that an Islamic bank is a welfare organization not a financial institution.³⁰⁷ There is also the misconception that the markup or profit margin imposed by Bank Islam is similar to *riba*. Such suspicion has to some extent tarnished the image of Bank Islam and raised questions on an otherwise perfectly legitimate method of financing.

As can be seen in Table 9.50 the nonparametric U-tests show that Muslims who banked with the interest-based banks were generally less aware of the Islamic concepts of financing compared with the depositors of Bank Islam.

In terms of the deposit accounts, it seems that depositors of both banking systems were equally aware only of the savings accounts. Both groups were also relatively less familiar with the profit-sharing general investment accounts compared with the depositors of Bank Islam.

In terms of the financing accounts, it may be worth noting that the depositors of both banks were typically not familiar with the Islamic methods of financing.³⁰⁸ However, the observed significance levels (as indicated by *) suggest that the conventional bank depositors were relatively more ignorant of the *Al-Bai Bithamin Ajil*, *Al-Musharakah*, *Mudarabah*, *Murabahah* and *Al-Qardul Hasan* compared with the depositors of Bank Islam at the 0.05 level of significance. However both types of depositors were equally unaware of the *Al-Ijarah* or lease financing which is the least known compared to other five methods of Islamic financing.

³⁰⁷ Malaysian Business June 1991:9.

³⁰⁸ As seen earlier in the frequency distribution Table 8.18 the values of the median and the mode show that the depositors of Bank Islam typically did not know about the Islamic methods of financing offered by Bank Islam. The same tendency is also noticed amongst the conventional bank depositors.

Table 9.50 — U-Tests Comparing the Mean Ranks of Depositors' Awareness of the Banking Services Provided By Bank Islam

Bank Service	Bank Islam	Conventional Bank	U-value	Significance
	Depositors	Depositors		
	Mean Rank	Mean Rank		
DEPOSIT:				
Savings Account	192.52	188.00	17425.0	.5543
Current Account	219.36	154.85	11790.0	.0000*
General Investment	204.60	173.09	14890.0	.0006*
FINANCING:				
Al-Bai Bithamin Ajil	208.00	168.88	14175.0	.0000*
Al-Musharakah	200.00	178.26	15770.0	.0094*
Mudarabah	202.62	175.53	15305.0	.0039*
Murabahah	201.00	177.53	15645.0	.0054*
Al-Ijarah	196.40	183.21	16610.0	.0759
Al-Qardul Hasan	200.55	178.09	15740.0	.0039*
FEE-BASED SERVICES:				
Foreign Exchange	192.17	188.44	17500.0	.6922
Remittances & Transfers	196.93	182.56	16500.0	.1342
Travellers' Cheque:	200.64	177.97	15720.0	.0109*

In terms of the fee-based services, depositors of both banking systems seems to be equally aware of the more commonly known foreign exchange and transfers services though the conventional depositors were typically less aware that travellers' cheques could also be bought at Bank Islam.

It can therefore be inferred from the above findings that Muslims who bank exclusively with the conventional banks are in general relatively less aware of the Islamic banking services available at Bank Islam. Even though the Bank Islam depositors were also typically not familiar with the Islamic financing products

offered by Bank Islam the religious motivation was strong enough to attract them to Bank Islam. Because of the lack of religious motivation, it seems that Muslims who banked with the conventional banks need to be educated and convinced of the relative merits of the Islamic financial products that Bank Islam can deliver as an incentive to bank with Bank Islam.

9.6 Summary of Findings

The findings obtained from the bank selection analysis of the Muslim depositors of Bank Islam on the one hand and the Muslim depositors of the conventional banks on the other will be summarized in this section. These findings may serve as signposts in the future development of the retail banking sector of Bank Islam as well provide some insights on how the market for Islamic banking services may be expanded.

- Bank Islam Depositors
 1. A majority of Bank Islam depositors did not bank exclusively at Bank Islam but held secondary accounts at the interest-based commercial banks.
 2. In relation to 1., deposits were made in the conventional banks mainly for the purpose of convenience specifically to take advantage of the extensive branch network and the ATM facility which Bank Islam still lacks.
 3. A majority of Bank Islam depositors who banked exclusively with Bank Islam had held accounts in the interest-based banks before the establishment of Bank Islam.
 4. Deposits were held in the conventional banks previously for the sake of safety and convenience rather than for the aim of earning interest.

5. Based on 1. and 3., the establishment of Islamic banking in the urban areas has only effected a transfer of resources within the market with little impact on mobilizing new deposits which the interest-based banks had failed to attract because of *riba*.
6. Depositors who banked exclusively with Bank Islam and depositors who banked both with Bank Islam and the conventional banks are equally loyal to the bank.
7. Depositors who bank exclusively with Bank Islam are more religiously committed in avoiding *riba*.
8. The most important factor that had influenced depositors to select Bank Islam as their primary bank was the overall Islamic characteristic of the bank. Contextual factors in the form of locational convenience and easy accessibility were second in important whilst social influence played a less important role in determining depositors' preference for Bank Islam.
9. Depositors had been strongly influenced by the knowledge that the operation of Bank Islam was totally run on Islamic principles. This implies that Bank Islam depositors are likely to prefer a fully-fledged Islamic bank rather than special Islamic counters at the conventional banks.
10. Savings account depositors have been motivated by the religious incentive to free their savings from interest and by the monetary incentive provided by the profits paid on the savings accounts.
11. The profit-sharing investment account had managed to attract only the high income depositors. The introduction of other forms of 'affordable' in-

vestment schemes may be more suitable to mobilize investible resources from the the medium income earners.

12. More than half of Bank Islam depositors tend to be influenced by the easy accessibility of the bank by public transport and a lesser proportion by the proximity of the Islamic bank from their homes or workplaces.
 13. A majority of Bank Islam depositors worked and lived more than 2 miles from the bank and were generally not concerned by the distance of Bank Islam from these two places.
 14. Depositors who were religiously motivated to bank with Bank Islam were also influenced by the accessibility of the bank by public transport.
 15. Depositors who were influenced by the accessibility of Bank Islam by public transport or by its convenient location from work or home were more likely to forgo Islamic banking for the sake of convenience.
- Muslim Depositors of Riba-Banks
 1. A majority of Muslims who banked only with the interest-based banks were either unsure or did not perceive that interest is prohibited in Islam.
 2. Muslims who bank with the interest-based banks are more likely to invest with the Amanah Saham Nasional compared with the Muslim depositors of Bank Islam.
 3. Convenience is the most important factor that has influenced urban Muslims to bank primarily with the interest-based banks.
 4. Urban Muslims who preferred to bank entirely with the interest-based banks

have been strongly influenced by the combination of three factors namely convenient location from work, the availability of the ATM and the extensive branch network of the conventional commercial banks.

5. Whilst the high income and more educated depositors who banked entirely with the interest-based banks were generally strongly influenced by locational and transactional convenience, the low income and less educated depositors were more concerned with the accessibility of the interest-based banks by public transport.
6. Muslim depositors who banked with the interest-based banks were generally not influenced by the interest-based financial services offered by these banks.
7. Social influence plays a less important role in attracting Muslim depositors to the interest-based banks.
8. On the whole convenience is the main reason why some Muslims choose to bank primarily with the interest-based banks.

Chapter X

Summary and Recommendations

10.1 Summary

This section summarizes the conclusions derived from this study.

- Justification for Islamic Banking

The justification for Islamic banking lies in the fact that Muslims view economics and finance as an integral part of the Islamic system of life. Economic relationships are very much governed by ethical values that the economic behaviour of the individual Muslim differs from that of the economic man in many respects. Even though the elements of the Islamic economic system may seem utopian in nature, it serves as the frame of reference in any Islamic economic analysis since it is the ultimate system that all Muslims wish to accomplish.

The freedom of individual enterprise in the Islamic economic system is guided by ethical restraints to remove the impediments to economic and social justice. One of the ways stated in the *Shariah* to eliminate these obstructions is by their prohibition. In the context of finance and banking the prohibition of *riba* is a key factor.

There is a general consensus that the rate of interest represents an element of *riba* and is therefore prohibited in Islam. As a general rule, *riba* consists of three main elements namely (i) an excess demanded over and above any borrowed funds (ii) this excess is fixed in relation to time and (iii) this excess is fixed in advance.

The prohibition of *riba* does not imply that capital has no price in the Islamic economy. The Quranic principle that Allah has forbidden *riba* and permitted trade³⁰⁹ broadly implies that the remuneration for capital is tied to profits. In relation to this, profitsharing serves as the most appropriate Islamic alternative to replace the interest-based debtor-creditor relationship in conventional banking.

- Literature Review

The review of the theoretical and empirical literature of the development of Islamic banking shows that there exists a dichotomy between the theory and practice of Islamic banking. The theory of Islamic banking advocates that the backbone of Islamic banking should be built on the notion of profitsharing both on the assets and liabilities side in order to achieve the socio-economic objectives of the Islamic economy. The alleged advantages of the profitsharing banking system is the relative stability of the system in withstanding shocks and its efficiency in the allocation and distribution of resources. The objective of Islamic banking, therefore, as conceived by Muslim economists, is not confined only to the elimination of *riba* but to introduce a profitsharing banking system which contributes positively towards justice and development. Empirically, though, whilst the mobilization of profitsharing deposits has been relatively successful, the adoption of profitsharing methods of financing on the asset side by Islamic banks either in the Islamic or conventional setting were below the theoretical expectations. The experience of Pakistan and Iran show that the elimination of *riba* from the entire banking system can be achieved without major problems but the conversion into a banking system based entirely on profitsharing and equity participation is more difficult and requires basic changes in the attitude of banks and society from debt-financing to

³⁰⁹ Quran 2:275

equity financing. Legal reforms to safeguard the interest of the bank and clients; and comprehensive retraining of staff to deal with project-related lending operations are also necessary to facilitate such transformation. Similarly, Islamic banks operating in interest-based environments in the Middle-East have proved their viability as an alternative to conventional banks. However, the concentration on short-term trade financing based on the markup rather than profitsharing to finance the productive sectors provides evidence that Islamic banks are not superior to their conventional counterpart as alleged in theory. This implies that the role of Islamic banking as an effective instrument in socio-economic development has still not been explored.

- The Malaysian Setting

The overview of the structure and development of the Malaysian economy has shown that the 'hostile' context in which the Islamic bank was forced to operate was further aggravated by the recessionary climate. When Bank Islam was opened in 1983, the Malaysian economy had just undergone a period of impressive growth in the 1970s and was about to face the uncertain futures associated with the onset of the recession. As a result the first half of the 1980s was a difficult and challenging period when structural adjustments had to conform to the impact of the recession. Following economic recovery in 1987, there was a distinct shift in development policy to promote the private sector and specifically manufacturing as the main engine of growth. It is therefore expected that the marketing strategies of financial institutions will be geared to finance private sector investments in the manufacturing industries.

It is also important to recognize that Islamic banking in Malaysia was intro-

duced in a relatively developed interest-based financial environment in which 38 commercial banks, 41 finance companies and 12 merchant banks came under the supervision of the Central Bank. At the same time, development banks and specialized institutions, designed both to finance development in specific economic sectors and to facilitate the achievement of the New Economic Policy, had also been established. A process of financial deepening was also taking place. With the introduction of a wide range of interest-based financial instruments for the money market the accumulation of financial assets was faster than the accumulation of non-financial wealth or GNP. There was also greater competition in retail banking within the banking sector. The market-oriented approach to interest-rate determination, computerisation and the ATMs; and the widespread network of branches of the major banks have created competition both amongst commercial banks and between commercial banks and finance companies.

- Bank Islam Malaysia Berhad

(i) Profile

The actual development of Islamic banking in Malaysia pertains to the evolution; and the legal, organizational and operational framework of Bank Islam Malaysia Berhad. The establishment of Bank Islam as the first fully-fledged Islamic bank in Southeast Asia may be attributed to a combination of two factors; specifically “the presence of an Islamically-conscious population with political muscle and a government that is not unsympathetic to the Islamic cause.”³¹⁰. The demand for Islamic banking from Malaysian-Muslims was triggered by the Islamic resurgence. In addition the feasibility of Islamic banking was attested by the impressive success of *Tabung Haji*. From the political perspective, the Malay-led government had the

³¹⁰ Ariff 1988:209

political will to respond to the demands of the Muslims who form the majority of the electorate. In general the favourable political climate has played a major role in leading to the birth of Bank Islam.

The operational framework of Bank Islam outlines a comprehensive range of Islamic banking services in compliance with the *Shariah*. On the asset side, these include *mudarabah* and *musharakah* as recommended in theory; and a range of trade-related methods of financing based on the markup. Initially, the Malaysian Government Investment Certificates (MGICs) have been created by the government to enable the Bank to participate in the money market. Subsequently, private debt certificates have also been developed to keep pace with the current developments in the Malaysian securities market. In addition, the Bank fulfils its social responsibility by giving *qard-al hasan* loans to the hard-core poor from its *zakat* funds.

(ii) Performance

Except for its capital base, the market shares of Bank Islam had expanded considerably until the end of the 1980s. By this date, its market shares of assets and deposits were 2 per cent and 2.4 per cent respectively putting it amongst the ranks of medium-sized banks by national comparison. It is however relevant to note that the capital base of Bank Islam was expanded in January 1992 following capital restructuring in conjunction with the Bank's public listing on the main board of the Kuala Lumpur Stock Exchange.

Even though the market share of Bank Islam is relatively small compared to the industry total, it has a competitive position amongst other interest-based banks of similar size. In 1990, its returns on equity were the highest relative to four other

public-listed medium-sized banks. This implies that Bank Islam has provided a more attractive return on investment to its shareholders. The capability of the management in generating profits from its assets has also improved as denoted by the annual increase in its pre-tax return on assets ratios; which also compare favourably with that of the other medium-sized banks.

The performance of Bank Islam in deposit mobilization does not seem to differ from that of Islamic banks in the other parts of the world. In particular, the bulk of its deposits is made up of investment accounts. Deposit growth in the initial two years was mainly attributable to the religious motivation as attested by the substantial flow of investment deposits despite relatively lower rates of returns offered by Bank Islam. This implies that Bank Islam has played a developmental role of mobilizing deposits that had not entered the financial system previously because of *riba*. Nevertheless, after the idle resources prior to the establishment of Bank Islam had been absorbed, further mobilization of investment deposits in particular, seemed to depend more on the expected rates of returns rather than piety; as indicated by the decrease in the total deposits base during the period of rising interest rates in 1990 and 1991. This implies that even though Bank Islam enjoyed a monopolistic position in the Islamic sector it does face competition for deposits from the interest-based banks.

In terms of the expansion of its branch network, however, Bank Islam has not reached the captive markets of Muslims in the rural areas. The Bank has concentrated its branch network mainly in the capital towns and in secondary towns having at least 10,000 Malay population.

On the asset side, the financing activities of Bank Islam had been constrained

mainly by the unfavourable loan climate during the recession initially; and the decline of its deposits base in recent years. Bank Islam had reacted to the hostile environment during its infancy by concentrating on trade-related and soft areas of finance. However, the continuous deemphasis on equity participation even after the recession reflects the corporate objective of Bank Islam; specifically “to operate as a commercial bank” which by its nature will be more inclined towards trade-related debt-financing rather than equity participation. Looking from this perspective, Bank Islam has proved its viability in the market.

In general, Bank Islam has played a limited role towards the socio-economic development of the Muslim community especially in terms of exploiting the benefits that can be reaped from profitsharing methods of financing. Equity-participation has only been confined to large corporations to minimize the risk of loss. Finance to the middle and lower income groups has been concentrated on housing. Like the other Islamic banks, the financing portfolio of Bank Islam has mainly been geared towards the provision of interest-free finance to the extent that *riba* is not involved in any of its transactions. This supports Nienhaus’ thesis that Islamic banks in a conventional environment do not differ significantly from the interest-based banks. The only ‘superiority’ of Bank Islam over its conventional counterparts is that a majority of its loans are in the longer term and the cost of borrowing does not rise with the rise in interest-rates.

- Depositors’ Survey - main conclusion

Since the findings of the survey have been summarized at the end of Chapter IX, it would be appropriate to present here only the main conclusion that is derived from it.

Our findings have shown that the depositors of Bank Islam are attracted to the Islamic bank purely because of the religious motivation to avoid *riba*. This implies that an Islamic bank operating in a relatively developed interest-based banking system can still create its own niche in the market for pious Muslims who are committed in avoiding *riba*. However, to expand its market share beyond this group of pious Muslims the Islamic bank needs to adapt itself to the demands of the market. Muslim depositors of the conventional banks are highly convenience-oriented. For them, the religious motivation is not a sufficient attraction to bank with Bank Islam. Our findings also show that these convenience-oriented Muslims are of high net-worth belonging to the high income group. These are potential depositors who should be the main targets of Islamic banks. The provision of convenience banking may be the most appropriate strategy to capture this potential market of Muslim depositors. Since the present package of Islamic banking provided by Bank Islam does not fulfill the banking needs of these depositors the introduction of Islamic banking counters by the conventional banks may serve as the second best solution to bring Islamic banking to a wider section of the Muslim population . Nevertheless, the dissemination of knowledge on Islamic banking and finance is an essential prerequisite to create an awareness of the Islamic alternative to western banking as well as to eliminate the misconceptions concerning *riba*, the cost-plus method of financing and the separation of funds by conventional banks operating Islamic counters. Unless these misconceptions are dealt with Islamic banking will not become fully acceptable to all Muslims in Malaysia.

10.2 Future Prospects

The future prospects of Islamic banking in Malaysia look bright. As Bank Islam is reaching the end of its protected monopoly position as a supplier of Islamic

banking services, the forthcoming amendments to the Islamic Banking Act 1983 and the Banking and Financial Act 1989 will permit all existing Malaysian financial institutions and commercial banks to offer Islamic banking services. In preparation, the Central Bank opened an Islamic Banking Sector in June 1992 to assist domestic commercial banks wishing to develop Islamic banking counters and to erect a supervisory structure for these Islamic banking services.

The government has also taken an active role in permitting public sector employees to make the choice between obtaining government loans on traditional or *riba*-free terms. A *Bai Bithamin Ajil* (deferred payment sale) scheme was launched in May 1992 which allows Malaysian civil servants to obtain financing for the purchase of cars without interest

Existing foreign banks have already displayed a willingness to expand their activities in this direction. For example the Standard Chartered Bank has introduced a deposit account called the interest-free 'Dividend Savings' account for depositors who do not want to accept interest on their savings. Deposits can be made with a minimum of M\$500 and would be invested by the Bank in the MGICs.

These moves should have an impact on both the supply of and the demand for Islamic banking services which suggest that Islamic banking is firmly established within the Malaysian economy. It seems that supply will be forthcoming in response to additional demand for these services. Therefore, the future output of Islamic banking services in Malaysia is likely to be demand-determined.

On the demand side it seems that there is unmet demand in the rural areas: given the more extensive branch networks of the interest-based banks which will be extending their range of banking services to include Islamic banking services,

this unmet demand should be moderated if not fully met when Bank Islam loses its monopoly position. Yet the question remains whether the pious rural Muslim population will be willing to bank with a *riba* bank even though it offers an Islamic banking facility. This is a topic for future research.

As for the future of Bank Islam, the bank is now playing a leading role in the development of the secondary market in Islamic financial instruments. It also has plans to develop the capital market by setting up an Islamic unit trust. Its leading role is likely to continue. It is envisaged that initiative and innovations in Islamic financial instruments will remain the domain of Bank Islam.

The opening of Islamic windows by the conventional banks is of course only one route to expand the supply of Islamic banking services. Another route would be an increase in Islamic banking establishments. A plausible option is the establishment of Islamic banking subsidiaries by the conventional banks which could solve the problem of the separation of funds. The establishment of specialized Islamic financial institutions such as an Islamic merchant bank, a *mudarabah* bank or a *musharakah* bank is also more appropriate for the provision of banking services based on profitsharing. Whilst promoting healthy competition, such moves are likely to be modest in scale since the market cannot obviously support many institutions supplying these services.

10.3 Further Research

The survey undertaken in this study has compared the bank selection decisions of Muslim depositors of Bank Islam and those of the conventional banks. However, the range of issues relating to the deposit side of the balance sheet is wider than this. It would for example be interesting to find out:

(i) whether the results presented here carry over to depositors in other parts of the country.

(ii) whether the 'service' expectations of the Islamic bank's depositors coincide with those of the bank officials.

(iii) whether rural and urban depositors have different characteristics when the branch network of Bank Islam reaches the rural areas.

Each of these issues can only be adequately addressed through substantial further research.

Another limitation of this study is its focus on the deposit side of the balance sheet. It would be interesting to carry out an in-depth analysis of Bank Islam's financing activities. For example a survey of business customers in receipt of financing from Bank Islam could serve to highlight the contribution of Bank Islam to the socio-economic development of Muslim entrepreneurs in Malaysia.

Also with the ending of Bank Islam's monopoly, comes the obvious concern about the likely impact on Bank Islam of the introduction of Islamic counters by the conventional banks. This too is an issue worthy of considerable further research.

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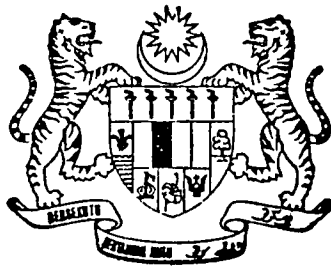
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Appendix A

Islamic Banking Act 1983



LAWS OF MALAYSIA

Act 276

ISLAMIC BANKING ACT 1983

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Date of Royal Assent . . . 9th March 1983

Date of publication in *Gazette* ... 10th March 1983

LAWS OF MALAYSIA**Act 276****ISLAMIC BANKING ACT 1983**

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- 5 Licence not to be granted in certain cases
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[Arrangement of Sections]

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ISLAMIC BANKING

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LAWS OF MALAYSIA

Act 276

ISLAMIC BANKING ACT 1983

An Act to provide for the licensing and regulation of Islamic banking business.

[]

BE IT ENACTED by the Duli Yang Maha Mulia Seri Paduka Baginda Yang di-Pertuan Agong with the advice and consent of the Dewan Negara and Dewan Rakyat in Parliament assembled, and by the authority of the same, as follows:

PART I

PRELIMINARY

1. (1) This Act may be cited as the Islamic Banking Act 1983 and shall come into force on such date as the Minister may by notification in the *Gazette* appoint

Short title,
commence-
ment and
application.

(2) This Act shall apply throughout Malaysia.

2. In this Act unless the context otherwise requires—

Interpreta-
tion

“branch” in relation to an Islamic bank includes a mobile branch of the bank and a branch established and maintained for a limited period only,

“Central Bank” means the Central Bank of Malaysia established by the Central Bank of Malaysia Ordinance 1958, 61/58.

“company” has the meaning assigned to it by the Companies Act 1965,

Act 125.

“corporation” has the meaning assigned to it by the Companies Act 1965;

“depositor” means a person who has an account at an Islamic bank, whether the account is a current account, a savings account, an investment account or any other deposit account,

“Islamic bank” means any company which carries on Islamic banking business and holds a valid licence; and all the offices and branches in Malaysia of such a bank shall be deemed to be one bank;

“Islamic banking business” means banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam;

“investment account liabilities” in relation to an Islamic bank means the deposit liabilities at that bank in respect of funds placed by a depositor with that bank of a fixed period of time under an agreement to share the profits and losses of that bank on the investment of such funds;

“licence” means a licence granted under section 3;

Act 102 “other deposit liabilities” in relation to an Islamic bank means the deposit liabilities at that bank other than savings account, investment account, sight and time liabilities and deposit liabilities from any other Islamic bank, any licensed bank under the Banking Act 1973 or the Central Bank,

Act 125. “public company” has the meaning assigned to it by the Companies Act 1965;

“savings account liabilities” in relation to an Islamic bank means the total deposits at that bank which normally require the presentation of passbooks or such other documents in lieu of passbooks as approved by the Central Bank for the deposit or withdrawal of moneys;

“share” means share in the share capital of a corporation and includes stock, except where a distinction between stock and share is expressed or implied;

Act 102 “sight liabilities” in relation to an Islamic bank means the total deposits at that bank which are repayable on demand, but does not include savings account liabilities or the deposits of any other Islamic bank, any licensed bank under the Banking Act 1973 or the Central Bank;

Act 125. “subsidiary” has the meaning assigned to it under section 5 of the Companies Act 1965;

“time liabilities” in relation to an Islamic bank means the total deposits at that bank which are repayable otherwise than on demand, but does not include savings account liabilities or the deposits of any other Islamic bank, any licensed bank under the Banking Act 1973 *Act 102* or the Central Bank

PART II

LICENSING OF ISLAMIC BANKS

3. (1) Islamic banking business shall not be transacted in Malaysia except by a company which is in the possession of a licence in writing from the Minister authorizing it to do so.

Islamic banking business to be transacted only by a licensed Islamic bank

(2) A company which desires authority to carry on Islamic banking business in Malaysia shall apply in writing through the Central Bank to the Minister for a licence under this section and shall supply—

- (a) a copy of the memorandum of association and articles of association or other instrument under which the company is incorporated, duly verified by a statutory declaration made by a senior officer of the company; and
- (b) such other document or information as may be called upon by the Minister.

(3) Upon receiving an application under subsection (2) the Central Bank shall consider the application and make a recommendation to the Minister stating whether a licence should be granted or not and the conditions, if any, to be attached to the licence

(4) Upon receiving an application under subsection (2) and the recommendation of the Central Bank under subsection (3), the Minister may, subject to section 4, grant a licence, with or without conditions, or refuse a licence

(5) The Central Bank shall not recommend the grant of a licence, and the Minister shall not grant a licence, unless the Central Bank or the Minister, as the case may be, is satisfied—

- (a) that the aims and operations of the banking business which it is desired to carry on will not involve any element which is not approved by the Religion of Islam; and

(b) that there is, in the articles of association of the bank concerned, provision for the establishment of a Syar'iah advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam.

(6) Any person who contravenes the provisions of this section shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment.

Minister
may vary
or revoke
condition
of licence

4. (1) The Minister may at any time, on the recommendation of the Central Bank, vary or revoke any existing condition of a licence or impose conditions or additional conditions.

(2) The Minister shall, prior to any action under subsection (1), notify his intention in writing to take such action to the Islamic bank concerned and shall give the bank an opportunity to submit within such period, being not less than fourteen days, as may be specified in the notification reasons why the condition of the licence should not be varied or revoked or conditions or additional conditions should not be imposed.

(3) Where a licence is subject to conditions, the Islamic bank shall comply with those conditions.

(4) Any Islamic bank which fails to comply with any condition of its licence shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit.

Licence not
to be
granted
in certain
cases

5. (1) No company shall be granted a licence under section 3 nor shall any company licensed thereunder carry on business in Malaysia without the written consent of the Minister if its capital funds unimpaired by losses or otherwise is less than the minimum amount.

(2) For the purposes of this section—

“capital funds” means paid-up capital and reserves and any other sources of capital as may be defined and computed in such manner as may be prescribed by notice in writing from time to time by the Central Bank;

“minimum amount” means such amount of capital funds to be maintained by an Islamic bank as may be prescribed by the Minister on the recommendation of the Central Bank by notification in the *Gazette*.

(3) The prescription of the minimum amount to be maintained under subsection (2) shall be complied with within such uniform period of grace being not less than three months as may be specified in the notification.

6. (1) No company shall be granted or shall hold a licence if the Minister is satisfied that it is or has become foreign-owned or controlled. Foreign-owned banks

(2) For the purposes of this section, a company shall be deemed to be foreign-owned or controlled if fifty per centum or more of its capital issued and paid-up is owned by or on behalf of persons who are not citizens of Malaysia, or if a majority of the persons having the direction, control or management of the company are not citizens of Malaysia.

7. Except with the consent in writing of the Central Bank, no Islamic bank may open a new branch, agency or office in any part of Malaysia or outside Malaysia. Opening of new branches

8. (1) Subject to subsection (2), every Islamic bank may establish a correspondent banking relationship with any bank outside Malaysia. Islamic bank may establish correspondent banking relationship with bank outside Malaysia

(2) The Central Bank may prescribe by notice in writing that no Islamic bank shall, except with the approval of the Minister on the recommendation of the Central Bank, establish a correspondent banking relationship with any bank established in any of the countries specified in the notification or with any bank owned or controlled by the government or an agency of the government of any such country.

9. Every Islamic bank shall pay to the Central Bank such annual licence fee as the Minister, on the recommendation of the Central Bank, may by notification in the *Gazette* prescribe. Licence fee

Restriction
of the use
of certain
words in an
Islamic
bank's
name

10. Except with the consent in writing of the Minister no Islamic bank shall be licensed by a name which includes any of the words "Central", "Commonwealth", "Federal", "Federation", "Malaysia", "Malaysian", "National", "Reserve" or "State" either in the National Language or in English or in any other language.

Revocation
of licence

11. (1) Subject to subsection (2), if any Islamic bank—

- (a) is pursuing aims, or carrying on operations, involving any element which is not approved by the Religion of Islam;
- (b) is carrying on its business in a manner detrimental to the interests of its depositors and other creditors;
- (c) has insufficient assets to cover its liabilities to the public;
- (d) is contravening any provision of this Act; or
- (e) has ceased to carry on banking business in Malaysia,

the Minister may, on the recommendation of the Central Bank, revoke any licence issued to such bank.

(2) The Minister shall, prior to any such revocation, notify his intention to take such action to the Islamic bank concerned and shall give the bank an opportunity to submit within such period, being not less than twenty-one days, as may be specified in the notification reasons why the licence should not be revoked.

(3) Where the licence of an Islamic bank has been revoked under subsection (1), the bank may within thirty days of the revocation appeal against the revocation to the High Court, which may make such order thereon as it thinks proper, including any direction as to the costs of the appeal.

(4) The Central Bank shall be entitled to be heard on any such appeal.

(5) The making of an appeal under this section shall in no way affect the exercise of the powers and duties of the Central Bank under sections 37, 39 and 40.

ISLAMIC BANKING

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12. (1) Where an order of revocation becomes effective under section 11— Effect of revocation of licence.

(a) notice of the revocation shall be published in the *Gazette*; and

(b) the Islamic bank shall as from the date of the notice cease to transact any banking business in Malaysia except as may be approved by the Minister on the recommendation of the Central Bank for the purposes of winding up of its banking business.

(2) The provisions of paragraph (b) of subsection (1) shall not prejudice the enforcement by any person of any right or claim against the bank or by the bank of any right or claim against any person.

13. The Central Bank shall cause to be published in the *Gazette* in each year a list of all Islamic banks to which licences have been issued under this Act, and if any licence is issued, revoked or surrendered during the interval between the publication of two such lists, notice thereof shall also be caused to be published in the *Gazette*. Publication of list of Islamic banks.

PART III

FINANCIAL REQUIREMENTS AND DUTIES OF ISLAMIC BANKS

14. (1) The Central Bank may require an Islamic bank to maintain capital funds, unimpaired by losses or otherwise, in such proportion to such assets of its branches and offices both in Malaysia and outside Malaysia or only of its branches and offices in Malaysia as may be prescribed from time to time by the Central Bank by notice in writing. Maintenance of capital funds

(2) "Capital funds" in subsection (1) shall have the meaning assigned to that expression in subsection (2) of section 5 but with such modifications as may be specified from time to time for the purposes of subsection (1) by the Central Bank by notice in writing

Maintenance
of reserve
funds

15. (1) Every Islamic bank—

- (a) shall maintain a reserve fund; and
- (b) before any dividend is declared shall transfer to the reserve fund out of the net profits of each year, after due provision has been made for *zakat* or taxation—
 - (i) so long as the amount of the reserve fund is less than fifty per centum of the paid-up capital, a sum equal to not less than fifty per centum of the net profits;
 - (ii) so long as the amount of the reserve fund is fifty per centum but less than one hundred per centum of the paid-up capital, a sum equal to not less than twenty-five per centum of the net profits.

(2) If the Central Bank is satisfied that the aggregate reserve fund of an Islamic bank is adequate for its business, it may by order in writing exempt the bank from the provisions of subsection (1) for a period of one year.

Percentage
of liquid
assets.

16. (1) The Central Bank may from time to time prescribe by notice in writing to each Islamic bank a minimum amount or amounts of liquid assets to be held by the bank at all times.

(2) The minimum amount or amounts of the assets so prescribed to be held shall be expressed in the form of—

- (a) a percentage or percentages which such assets shall bear to the sight, savings account, time and other deposit liabilities of each Islamic bank and such other liabilities thereof as may be determined by the Central Bank, either jointly or separately; and
- (b) a percentage which such assets shall bear to the investment account of each Islamic bank;

and such percentage or percentages may be varied by the Central Bank from time to time by notice in writing to the bank.

ISLAMIC BANKING

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(3) Whenever the Central Bank issues a notice under subsection (1) each Islamic bank shall be allowed such uniform period of grace, being not less than one week, as may be specified in that notice in which to comply with the provisions thereof.

(4) An Islamic bank shall not, during any period in which it has failed to comply with any notice under subsection (1), without the approval of the Central Bank, lend or advance any money to any person.

(5) For the purpose of computing the minimum amount or amounts of liquid assets under this section and the sight, savings account, investment account, time and other deposit liabilities of an Islamic bank carrying on business in Malaysia and elsewhere and such other liabilities of such bank as may be determined by the Central Bank, the offices and branches of such bank in Malaysia shall be deemed to constitute a separate bank carrying on business in Malaysia.

(6) For the purposes of this section liquid assets shall be—

- (a) notes and coin which are legal tender in Malaysia;
- (b) balances at the Central Bank, not including the reserve specified in paragraph (c) of subsection (1) of section 37 of the Central Bank of Malaysia Ordinance 1958;
- (c) investment certificates issued under the Government Investment Act 1983; and
- (d) such other assets as may be approved by the Minister on the recommendation of the Central Bank.

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(7) The Central Bank may by notice in writing require each Islamic bank to render such return or returns as the Central Bank deems necessary for the implementation of this section

(8) Any Islamic bank which fails to comply with any of the provisions of this section shall be liable to pay, on being called upon to do so by the Central Bank, a penalty of not more than one-tenth of one per centum of the amount of the deficiency for every day during which the deficiency continues.

(9) Any Islamic bank which fails or refuses to pay a penalty under subsection (8) shall be guilty of an offence under this Act

Auditor
and
auditor's
report
Act 125

17. (1) Notwithstanding the provisions of the Companies Act 1965, every Islamic bank shall appoint annually an auditor approved by the Minister.

(2) The Minister on the recommendation of the Central Bank may appoint an auditor—

(a) if the Islamic bank fails to appoint an auditor;
or

(b) if he considers it desirable that another auditor should act with the auditor appointed under subsection (1),

and may fix the remuneration to be paid by the Islamic bank to that auditor.

(3) The duties of the auditor appointed under subsections (1) and (2) for an Islamic bank shall be—

(a) to carry out for the year in respect of which he is appointed an audit of the accounts of the bank; and

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(b) to make a report in accordance with section 174 of the Companies Act 1965 upon the annual balance sheet and profit and loss account of the bank.

(4) The report of the auditor referred to in paragraph (b) of subsection (3) shall be laid together with the report of the directors of the Islamic bank at the annual general meeting of the bank; and a statutory declaration made by a senior officer of the bank to the effect that the report was so laid shall accompany the documents forwarded under paragraph (c) of subsection (1) of section 18.

(5) No person having an interest in an Islamic bank otherwise than as a shareholder, and no director or officer of that bank, shall be eligible for appointment as an auditor for that bank; and any person appointed as auditor to an Islamic bank who after such appointment acquires such interest or becomes a director or an officer of that bank shall forthwith cease to be the auditor.

ISLAMIC BANKING

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(6) The duties, powers and liabilities imposed and conferred by section 33 in relation to an investigation by the Central Bank of the affairs of an Islamic bank under section 31 or 32 are hereby imposed and conferred in relation to auditors appointed under this section.

(7) Any Islamic bank which fails to comply with the requirements of subsection (4) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit.

18. (1) Every Islamic bank shall—

(a) exhibit in a conspicuous position in every office or place of business in Malaysia—

Audited
balance
sheet.

(i) a copy each of its latest audited annual balance sheet, profit and loss account, together with any note thereon, and the report of the auditor;

(ii) the full names of all its directors; and

(iii) the names of all subsidiaries for the time being of the bank;

(b) within fourteen days of the laying of its accounts at its annual general meeting publish in at least two daily newspapers published in Malaysia and approved by the Central Bank a copy each of its latest audited annual balance sheet, profit and loss account, together with any note thereon, and the report of the auditor; and

(c) within six months after the close of each financial year or such further period as the Central Bank may approve, forward to the Central Bank—

(i) two copies each of its latest audited annual balance sheet, profit and loss account, together with any note thereon, and the reports of the auditor and the directors;

(ii) in the case of an Islamic bank with branches outside Malaysia, two copies each of its latest audited annual balance sheet and profit and loss account in respect of its operations in Malaysia, and

two copies each of its latest audited annual balance sheet and profit and loss account in respect of its operations in each country outside Malaysia.

(2) The form and content of the balance sheet and profit and loss account shall, together with the report of the directors, be as approved by the Central Bank.

(3) The Central Bank may require any Islamic bank to submit such further or additional information as it may deem necessary either by way of explanation, amplification or otherwise with regard to the balance sheets and profit and loss accounts forwarded by that bank under paragraph (c) of subsection (1) and that information shall be submitted within such period and in such manner as the Central Bank may require.

(4) Any Islamic bank which fails to comply with the provisions of this section shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit.

Statistics
to be
furnished

19. (1) Every Islamic bank shall send to the Central Bank in such form as may be prescribed by the Central Bank—

- (a) a statement showing the liabilities and assets of its banking offices and branches in Malaysia at the close of business on the last business day of each month within such period as may be prescribed by notice in writing from time to time by the Central Bank;
- (b) a statement giving an analysis of loans, advances and investment of its banking offices and branches in Malaysia as at such intervals and within such period as may be prescribed by notice from time to time by the Central Bank;
- (c) not later than six months after the close of its financial year, a statement showing the income and expenditure in respect of its business in Malaysia;
- (d) notwithstanding the provisions of subsection (3) of section 34, a statement showing such credit information of its customers as is required for the purposes of the credit bureau established

ISLAMIC BANKING

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under section 30 (1) (*mmm*) of the Central Bank of Malaysia Ordinance 1958 at such intervals and within such period as may be prescribed by notice in writing from time to time by the Central Bank; and

(e) any such statistical information as may be requested by the Central Bank.

(2) Except for the purposes of paragraph (d) of subsection (1), any information received from a bank under this section shall be regarded as secret between that bank and the Central Bank.

(3) Any Islamic bank which fails to comply with any requirement set out in subsection (1) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding four thousand ringgit for every day during which the default continues.

(4) It shall be the responsibility of the Central Bank to prepare and publish consolidated statements aggregating the figures in the returns furnished under paragraphs (a) and (b) of subsection (1).

20. An Islamic bank which operates branch offices or agencies outside Malaysia shall furnish to the Central Bank any information relating to the operations of such offices or agencies as may be requested by the Central Bank

Information on foreign branches

PART IV

OWNERSHIP, CONTROL AND MANAGEMENT OF ISLAMIC BANKS

21. (1) Whenever a change is about to occur in the control of any Islamic bank, the bank shall report the proposed change to the Central Bank.

Information on change in control of Islamic banks

(2) Whenever a loan or advance is made by any Islamic bank secured in the aggregate by twenty per centum or more of the paid-up capital shares of any other Islamic bank or of any licensed bank under the Banking Act 1973 incorporated in Malaysia or of any finance company licensed under the Finance Companies Act 1969, the Islamic bank shall report the fact to the Central Bank

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(3) The reports required to be made under subsection (2) shall contain the following—

- (i) the names and addresses of the borrowers;
- (ii) the name of the Islamic bank, the licensed bank, or finance company issuing the shares by which the loan or advance is secured,
- (iii) the number of shares by which the loan or advance is secured; and
- (iv) the amount of the loan or advance.

(4) The reports under subsections (1) and (2) shall be in addition to any report which may be required pursuant to the provisions of any other written law.

(5) For the purposes of this section, the expression “control” in relation to an Islamic bank means the possession directly or indirectly of the power to direct or cause the direction of the management and policy of the bank

(6) Any Islamic bank which fails to comply with the provisions of subsection (1) or (2) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit.

Sanction
for recons-
truction
etc., of
bank
required

22. (1) Every Islamic bank shall obtain the approval of the Minister of any proposed—

(a) arrangement or agreement—

- (i) for the sale or disposal of its shares or business, or
- (ii) affecting voting power, management or other matters,

which will result in a change in the control or management of the bank; and

(b) scheme—

- (i) for reconstruction of the bank, or
- (ii) for amalgamation, merger or otherwise between the bank and any other corporation,

wherein the whole or any part of the undertaking or the property of the bank is to be transferred to another corporation

ISLAMIC BANKING

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(2) The Minister, on the recommendation of the Central Bank, may approve or refuse to allow the proposed arrangement, agreement or scheme, but the approval of the Minister shall not be unreasonably withheld.

23. (1) Without prejudice to anything contained in the Companies Act 1965, any person who is a director, manager, secretary or other officer concerned in the management of an Islamic bank shall cease to hold office —

Disqualifica-
tion of
directors
and
employees
of banks
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- (a) if he becomes a bankrupt, suspends payment or compounds with his creditors; or
- (b) if he is convicted of an offence involving dishonesty or fraud.

(2) No person who has been a director of, or directly concerned in the management of, an Islamic bank or a licensed bank under the Banking Act 1973 which has been wound up by a court shall, without the express authority of the Minister, act or continue to act as a director of, or be directly concerned in the management of, any Islamic bank

Act 102

(3) Any person who acts in contravention of subsection (1) or (2) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment

PART V

RESTRICTIONS ON BUSINESS

24. (1) No Islamic bank shall—

- (a) pay any dividend on its shares until all its capitalized expenditure (including preliminary expenses, organization expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) has been completely written off;
- (b) grant an advance, loan or credit facility against the security of its own shares; or

Restrictions
on payment
of dividends
and grant
of advances
and loans.

(c) grant unsecured advances, unsecured loans or unsecured credit facilities in excess of, in the aggregate and outstanding at any one time, ten thousand ringgit to any corporation which is deemed to be related to the bank as described in section 6 of the Companies Act 1965, other than an Islamic bank, a licensed bank under the Banking Act 1973, a finance company licensed under the Finance Companies Act 1969, or any other financial institution approved by the Central Bank.

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Act 6

(2) For the purpose of this section "unsecured advances", "unsecured loans" and "unsecured credit facilities" mean respectively advances, loans and credit facilities made without security, or, in respect of any advance, loan and credit facility made with security, any portion thereof which at any time exceeds the market value of the assets constituting the security or, where the Central Bank is satisfied that there is no established market value, the value made on the basis of a valuation approved by the Central Bank.

Prohibition
of loans,
etc., to
directors
officers and
employees

25. (1) Except as provided under paragraph (c) of subsection (1) of section 24 and subsection (2) of this section, no Islamic bank shall grant advances, loans or credit facilities to—

- (a) any of its directors, officers or employees or other persons being persons receiving remuneration from it (other than accountants, advocates and solicitors, architects, estate agents, doctors and any other persons receiving remuneration from it in respect of their professional services),
- (b) any firm in which any of its directors, officers or employees is interested as partner, manager, agent or guarantor,
- (c) any corporation in which any of its officers or employees is a director, manager, agent or guarantor, or any corporation in the shares of which any of its officers or employees has any material interest as determined by the Central Bank;

(d) any corporation in which any of its directors (not being an executive director, he being within the ambit of the provisions of paragraph (c) pursuant to subsection (3)) is a member, director, manager, agent or guarantor, or any corporation in the shares of which any such director of the Islamic bank has any interest whatsoever directly or indirectly; or

(e) any individual for whom any of its directors, officers or employees is a guarantor

(2) An Islamic bank may grant to any of its officers or employees loans which are provided under its appropriate scheme of service and, where the bank is satisfied that special or compassionate circumstances exist, a loan not exceeding at any one time six months' remuneration of that officer or employee on such terms and conditions as the bank thinks fit.

(3) The provisions of paragraph (c) of subsection (1) and of subsection (2) shall also apply to the executive directors of Islamic banks

(4) The provisions of paragraph (d) of subsection (1) shall not apply to the granting of advances, loans or credit facilities by an Islamic bank to—

(a) a corporation which is listed on a recognized stock exchange and in the shares of which no director of that Islamic bank has, directly or indirectly, any material interest as determined by the Central Bank; and

(b) a public company in which a director of that Islamic bank has no interest in his personal capacity, as determined by the Central Bank:

Provided that for the purposes of this subsection the director concerned is not an executive director of that Islamic bank

(5) For the purposes of this section, "director", "officer" or "employee" includes a spouse, parent or child of a director, an officer or employee.

Restriction
on grant of
loan
advance
or credit
facility
under
section
25 (4)

26. No Islamic bank shall grant any advance, loan or credit facility under the exemption referred to in subsection (4) of section 25 unless the following conditions are satisfied

- (a) that the advance, loan or credit facility meets the standards of credit-worthiness required of other applicant borrowers,
- (b) that the terms of the advance, loan or credit facility are not less favourable to the bank than those offered to others,
- (c) that the grant of the advance, loan or credit facility will serve the best interest of the bank; and
- (d) that the advance, loan or credit facility has been approved by the votes of not less than two-thirds of all the other directors of the bank at a duly constituted meeting of the full board of directors and the approval has been recorded in the minutes of that meeting

Restriction
of credit to
single
customer

27. (1) No Islamic bank shall grant any customer any credit facilities or incur any other liabilities on his behalf to an aggregate amount in excess of such percentage as may be determined from time to time by the Central Bank in relation to such bank's capital funds unimpaired by losses or otherwise

(2) Subsection (1) shall not apply to—

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(a) transactions with other Islamic banks, with licensed banks under the Banking Act 1973 and with finance companies licensed under the Finance Companies Act 1969;

(b) any facilities granted in respect of imports into or exports from Malaysia or trade within Malaysia against letters of credit or bills of exchange; or

(c) any other transactions which the Central Bank may approve from time to time

(3) For the purposes of subsection (1), the expression "capital funds" shall have the meaning assigned to it by subsection (2) of section 5

28. (1) Every director of an Islamic bank who is in any manner whatsoever, whether directly or indirectly, interested in an advance, loan or credit facility or proposed advance, loan or credit facility from that Islamic bank shall as soon as practicable declare the nature of his interest to the board of directors of that Islamic bank and the secretary of that Islamic bank shall cause such declaration to be circulated forthwith to all the directors

Disclosure
of interests
by directors

(2) The requirements of subsection (1) shall not apply in any case where the interest of the director consists only in being a member or creditor of a corporation which is interested in an advance, loan or credit facility or proposed advance, loan or credit facility from that Islamic bank if the interest of the director may properly be regarded as not being a material interest

(3) For the purposes of subsection (1), a general notice given to the board of directors of an Islamic bank by a director to the effect that he is an officer or member of a specified firm or a member of a specified corporation and he is to be regarded as interested in any advance, loan or credit facility which may, after the date of the notice, be made to that firm or corporation shall be deemed to be a sufficient declaration of interest in relation to any advance, loan or credit facility so made if—

- (a) it specifies the nature and extent of his interest in a specified firm or corporation;
- (b) his interest shall not be different in nature or greater in extent than the nature and extent so specified in the notice at the time any advance, loan or credit facility is made; and
- (c) it is given at the meeting of the directors or the director takes reasonable steps to ensure that it is brought up and read at the next meeting of the directors after it is given

(4) Every director of an Islamic bank who holds any office or possesses any property whereby whether directly or indirectly duties or interest might be created in conflict with his duties or interest as a director shall declare at a meeting of the directors of the Islamic bank the fact and the nature, character and extent of the conflict

(5) The declaration referred to in subsection (4) shall be made at the first meeting of the directors held—

- (a) after he becomes a director of the Islamic bank; or
- (b) (if already a director) after he commenced to hold office or to possess the property as the case may require.

(6) The secretary of the Islamic bank shall cause to be brought up and read any declaration made under subsection (1) or (4) at the next meeting of the directors after it is given, and shall record any declaration made under this section in the minutes of the meeting at which it was made or at which it was brought up and read.

(7) Any director who acts in contravention of subsection (1) or (4) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment.

Limitation
on credit
facility for
purpose of
financing
the purchase
or holding
of shares

29. (1) Any credit facility granted by any Islamic bank to any person for the purpose of financing the purchase or the holding of shares shall not exceed such percentage of the market value of the shares at the time the credit facility is granted, as may be directed by the Central Bank in writing.

(2) A credit facility granted under this section to any person shall be accounted for in an account separate from that kept for any other credit facility granted to him.

(3) The Central Bank may give direction in writing to any Islamic bank in respect of the following matters, that is to say—

- (a) the basis and method for determining the market value of shares held as security for such credit facility;
- (b) the withdrawal of funds or shares by the person to whom such credit facility was granted;
- (c) the substitution of other shares for shares held as security for such credit facility; and
- (d) such other matters as may be deemed necessary.

ISLAMIC BANKING

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(4) Any Islamic bank which acts in contravention of the provisions of this section or any direction given under this section shall be guilty of an offence under this Act

30. Any Islamic bank, if at any time called upon in writing by the Central Bank to do so, shall satisfy it by the production of such evidence or information as it may require that the bank is not acting in contravention of any of the provisions of sections 24, 25, 26, 27 and 29

Proof of compliance with sections 24, 25, 26, 27 and 29

PART VI

POWERS OF SUPERVISION AND CONTROL OVER ISLAMIC BANKS

31. The Central Bank shall from time to time investigate, under conditions of secrecy, the books, accounts and transactions of each Islamic bank and of any branch agency or office outside Malaysia opened by an Islamic bank

Investigation of banks

32. The Minister may at any time direct the Central Bank to make an investigation, under conditions of secrecy, of the books, accounts and transactions of an Islamic bank, if he has reason to believe such Islamic bank is carrying on its business in a manner detrimental to the interests of its depositors and other creditors, or has insufficient assets to cover its liabilities to the public, or is contravening the provisions of this Act or of the Central Bank of Malaysia Ordinance 61/58 1958.

Special investigation of banks

33. (1) Subject to subsection (2), for the purposes of an investigation under section 31 or 32, an Islamic bank shall afford the Central Bank access to its books, accounts and documents and shall give such information and facilities as may be required to conduct the investigation

Production of bank's books and documents

(2) Books, accounts and documents shall not be required to be produced at such times and at such places as shall interfere with the proper conduct of the normal daily business of the bank concerned

(3) Any Islamic bank which fails to allow access to its books, accounts and documents or to give information or facilities in accordance with subsection (1) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding four thousand ringgit for every day during which the default continues.

(4) For the purposes of an investigation under section 31 or 32 all officers and employees of the Central Bank shall be deemed to be public servants within the meaning of the Penal Code.

FMS
Cap 15

Banking
secrecy

34. (1) Except as provided in sections 31 and 32, *nothing in this Act shall authorize the Minister to direct the Central Bank, or shall authorize the Central Bank, to enquire specifically into the affairs of any individual customer of any Islamic bank and any incidental information relating to the affairs of the individual customer obtained by the Central Bank in the course of an inspection or investigation made by the Central Bank under the provisions of this Act shall be secret between the Central Bank and that bank.*

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(2) Nothing in this section shall be deemed to limit any powers conferred upon the High Court or a Judge thereof by the Bankers' Books (Evidence) Act 1949 or to prohibit obedience to an order made under that Act.

(3) Except with the consent of the Central Bank in writing and to the extent specified therein, no officer of any Islamic bank and no person who by reason of his capacity or office has by any means access to the records of that bank, registers or any correspondence or material with regard to the account of any individual customer of that bank shall give, divulge or reveal any information whatsoever regarding the moneys or other relevant particulars of the account of the customer unless—

- (a) the customer or his personal representative gives his permission so to do
- (b) the customer is declared bankrupt; or
- (c) the information is required to assess the creditworthiness of the customer relating to a *bona fide* commercial transaction or a prospective commercial transaction

(4) The provisions of subsection (3) shall not apply to the giving of information to auditors appointed under section 17, officers and employees of the bank who are resident in Malaysia

(5) Any person who acts in contravention of the provisions of this section shall be guilty of an offence and shall on conviction be liable to a fine not exceeding forty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment

35. (1) Every Islamic bank shall send to the Central Bank within such period as may be prescribed by notice in writing from time to time by the Central Bank after the last day of each month a statement in the form to be prescribed by the Central Bank showing particulars of all advances, loans or credit facilities granted by it to—

Action to be taken if advances are against interests of depositors

(a) any corporation which is deemed to be related to the bank as described in section 6 of the Companies Act 1965;

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(b) any corporation or public company referred to in subsection (4) of section 25; and

(c) any individual in whom and any firm or corporation in which any of its directors is interested, directly or indirectly, as declared under the provisions of section 28, other than advances, loans and credit facilities particulars of which have already been supplied pursuant to the preceding paragraphs.

(2) If on examination of the particulars supplied by an Islamic bank under subsection (1) it appears to the Central Bank that any such advance, loan or credit facility is being granted to the detriment of the interests of the depositors of that bank, the Central Bank may by order in writing prohibit that bank from granting any further advance, loan or credit facility or impose such restrictions on the grant thereof as the Central Bank thinks fit, and may further direct that bank to secure repayment of any such advance, loan or credit facility within such time and to such extent as may be specified in the order

(3) Any Islamic bank which has been issued with an order by the Central Bank pursuant to this section may appeal in writing to the Minister, who may, as he thinks fit, confirm, vary or revoke the order of the Central Bank

Banks
unable
to meet
obligations
to inform
Central
Bank

36. An Islamic bank which considers that it is likely to become unable to meet its obligations or is about to suspend payment shall forthwith inform the Central Bank of that fact.

Action by
Central
Bank
if bank
unable to
meet obliga-
tions or
conducting
business to
the detri-
ment of
depositors

37. (1) Where—

(a) an Islamic bank informs the Central Bank—

(i) that it considers that it is likely to become unable to meet its obligations; or

(ii) that it is about to suspend payment;

(b) an Islamic bank becomes unable to meet its obligations or suspends payment; or

(c) after an investigation is made under section 31 or 32 the Central Bank is of the opinion that an Islamic bank—

(i) is following unsound or improper practices;

(ii) is likely to become unable to meet its obligations or is about to suspend payment;

(iii) has contravened or failed to comply with any provision of this Act;

(iv) has contravened or failed to comply with any condition imposed on its licence; or

(v) is likely to be carrying on its business in a manner detrimental to the interests of its depositors.

the Central Bank, with the concurrence of the Minister, may exercise such one or more powers specified in subsection (2) as it deems to be necessary

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(2) Subject to subsection (1), the Central Bank may—

- (a) issue orders to the bank to take such steps as the Central Bank may consider necessary to rectify the matter and the bank shall carry out such orders within such time as may be prescribed by the Central Bank;
 - (b) prohibit the bank from extending any further advance, loan or credit facility for such period or periods as may be specified and subject to such exceptions if any and other conditions as the Central Bank may impose;
 - (c) remove from office any of its directors or appoint any person as its director;
 - (d) appoint a person to advise the bank on the proper conduct of its business;
 - (e) assume control of, and carry on, the business of the bank or appoint some other person to assume control of, and carry on, the business of the bank; or
 - (f) present a petition to the High Court for the winding up of the bank by the Court.
- (3) Where the Central Bank has appointed a person—
- (a) to be a director of the bank under paragraph (c) of subsection (2);
 - (b) to advise the bank on the proper conduct of its business under paragraph (d) of subsection (2); or
 - (c) to assume control of, and carry on, the business of the bank under paragraph (e) of subsection (2),

the Central Bank may fix the remuneration and expenses to be paid to that person by the bank.

38. Where the Central Bank has acted under paragraph (c) of subsection (2) of section 37 with respect to an Islamic bank, the following provisions shall have effect—

- (a) notwithstanding anything contained in the Companies Act 1965 and the articles of association of the bank, the rights of the members or holders of shares to elect directors of

Effect of removal of office of director or appointment of a director of a bank by the Central Bank
Act 125

the bank in place of those who are removed from office by the Central Bank shall cease to be exercisable,

(b) any director removed from office under that paragraph shall cease to hold office, and shall not be entitled to claim any compensation for the loss or termination of office; and

(c) every removal or appointment under that paragraph shall be final and conclusive and shall not be questioned in any Court.

Control of
Islamic
bank by
Central
Bank

39. (1) Where the Central Bank has assumed or has appointed another person to assume control of the business of an Islamic bank in pursuance of paragraph (c) of subsection (2) of section 37, the Central Bank or that person shall, subject to subsection (2), remain in control of the bank and continue to carry on the business of the bank in the name and on behalf of the bank until such time as the Central Bank is satisfied that the reasons for which it assumes control or has appointed another person to assume control have ceased to exist.

(2) Where the Central Bank has assumed control, or has appointed another person to assume control, of the business of an Islamic bank in pursuance of paragraph (c) of subsection (2) of section 37 the High Court may, upon application of the bank, order that the Central Bank shall cease to control the business of the bank as from a date specified in the order if the High Court is satisfied that it is no longer necessary for the protection of the depositors of the bank that the Central Bank should remain in control of the business of the bank

(3) Where the Central Bank has assumed control, or has appointed another person to assume control, of the business of an Islamic bank in pursuance of paragraph (c) of subsection (2) of section 37, or ceased to control the business of an Islamic bank in pursuance of this section, the Central Bank shall notify that fact in the *Gazette*.

40. (1) Where the Central Bank has assumed control, or has appointed another person to assume control, of the business of an Islamic bank in pursuance of paragraph (e) of subsection (2) of section 37, the Islamic bank shall submit its business to the control of the Central Bank or to that person and shall provide the Central Bank with such facilities as the Central Bank requires to carry on the business of that bank.

Islamic bank under control of Central Bank to co-operate with Central Bank.

(2) Any Islamic bank which fails to comply with subsection (1) or with any requirement of the Central Bank thereunder shall be guilty of an offence and shall on conviction be liable to a fine not exceeding four thousand ringgit for every day during which the default continues.

41. Any reference in this Part to an Islamic bank shall be read as including a reference to a subsidiary of an Islamic bank.

Extension of jurisdiction to subsidiaries of banks

42. (1) The Central Bank may, with the approval of the Minister, if it considers it to be in the interests of the depositors of an Islamic bank, make an order prohibiting the bank from carrying on banking business or from doing or performing any act or function connected with banking business or any aspect thereof as may be specified in the order.

Moratorium

(2) The Central Bank may, with the approval of the Minister, if it considers it to be in the interests of the depositors, apply to the High Court for an order staying the commencement or continuance of any proceedings by or against the bank in regard to any business of the bank. Such an order shall be valid for a period not exceeding six months.

(3) So long as an order under subsection (1) remains in force the licence granted to the bank under this Act shall be suspended.

(4) Where an order has been made under subsection (1), the Central Bank shall notify that fact in the *Gazette*

Amendment
of bank's
constitution

43. (1) Every Islamic bank shall, prior to the making of any amendment or alteration in the memorandum of association or articles of association or other instrument under which it is incorporated, furnish to the Central Bank particulars in writing of such proposed amendment or alteration for its approval.

(2) Every Islamic bank shall, within three months after the making of any amendment or alteration in the memorandum of association and articles of association or other instrument under which it is incorporated, furnish to the Minister through the Central Bank particulars in writing (verified by a statutory declaration made by a senior officer of the bank) of such amendment or alteration.

(3) Any Islamic bank which fails to comply with the requirements of subsection (1) or (2) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding two thousand ringgit for every day during which the default continues.

PART VII

MISCELLANEOUS

Indemnity

44. (1) Neither the Government nor the Central Bank nor any officer of either shall be subject to any action, claim or demand by or liability to any person in respect of anything done or omitted to be done in good faith in pursuance or in execution or intended execution, or in connection with the executing or intended execution, of any power conferred upon the Government, Central Bank or the officer by this Act.

(2) For the purposes of this section a Minister and any public officer shall be deemed to be an officer of the Government; and the Governor and Deputy Governor of the Central Bank and any director or employee thereof and any person holding any office therein or appointed by the Central Bank under paragraph (c), (d) or (e) of subsection (2) of section 37 shall be deemed to be an officer of the Central Bank.

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45. Where an Islamic bank becomes unable to meet its obligations or suspends payments, the assets of the bank in Malaysia shall be available to meet all sight and savings account liabilities of the bank in Malaysia; and such liabilities shall have priority over all other liabilities of the bank.

Priority of
sight and
savings
account
liabilities.

46. (1) Any person who, being a director or manager of an Islamic bank—

Penalties on
directors
and
managers.

(a) fails to take all reasonable steps to secure compliance by the bank with the requirements of this Act and of the Central Bank of Malaysia Ordinance 1958 (hereafter in this section referred to as “the Ordinance”); or

61/58.

(b) fails to take all reasonable steps to ensure the correctness of any statement submitted under the provisions of this Act or the Ordinance,

shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment.

(2) In any proceedings against a person under subsection (1) it shall be a defence to prove that he has reasonable grounds to believe that another person was charged with the duty of securing compliance with the requirements of this Act or the Ordinance or with the duty of ensuring that those statements were accurate and that that person was competent and in a position to discharge that duty.

(3) A person shall not be sentenced to imprisonment for any offence under subsection (1) unless in the opinion of the Court he committed the offence wilfully.

47. Any director, manager, trustee, auditor, employee or agent of any Islamic bank who—

Offences by
directors,
employees
and agents

(a) wilfully makes or causes to be made a false entry in any book of record or in any report, slip, document or statement of the business, affairs, transactions, condition, assets or accounts of the bank; or

(b) wilfully omits to make an entry in any book of record or in any report, slip, document or statement of the business, affairs, transactions, condition, assets or accounts of the bank, or wilfully causes any such entry to be omitted; or

- (c) wilfully alters, abstracts, conceals or destroys an entry in any book of record or in any report, slip, document or statement of the business, affairs, transactions, condition, assets or accounts of the bank, or wilfully causes any such entry to be altered, abstracted, concealed or destroyed,

shall be guilty of an offence and shall on conviction be liable to a fine not exceeding fifty thousand ringgit or to imprisonment for a term not exceeding five years or to both such fine and imprisonment.

Offences by
companies,
etc, and by
servants and
agents

48. (1) Where any offence against any provision of this Act has been committed by a corporation, firm, society or other body of persons, any person who at the time of the commission of the offence was a director, manager, secretary or other similar officer thereof or was purporting to act in such capacity shall be deemed to be guilty of that offence unless he proves that the offence was committed without his consent or connivance and that he exercised all such diligence to prevent the commission of the offence as he ought to have exercised, having regard to the nature of his functions in that capacity and to all the circumstances.

(2) Where any person would be liable under this Act to any punishment or penalty for any act, omission, neglect or default, he shall be liable to the same punishment or penalty for every such act, omission, neglect or default of any clerk, servant or agent, or of the clerk or servant of the agent, provided that the act, omission, neglect or default was committed by the clerk or servant in the course of his employment, or by the agent when acting on behalf of the person, or by the clerk or servant of the agent when acting in the course of his employment in such circumstances that had the act, omission, neglect or default been committed by the agent his principal would have been liable under this section.

Prohibition
on receipt of
commission
by staff

49. Any director, officer or employee of an Islamic bank, or other persons being persons receiving remuneration from the Islamic bank, who asks for or receives, consents or agrees to receive any gift, commission, emolument, service, gratuity, money, property or thing of value for his own personal benefit or advantage or

for that of any of his relatives, from any person other than from that bank, for procuring or endeavouring to procure for any person any advance, loan or credit facility from that bank or the purchase or discount of any draft, note, cheque, bill of exchange or other obligations by the bank, or for permitting any person to overdraw any account with that bank, shall be guilty of an offence and shall on conviction be liable to a fine not exceeding twenty thousand ringgit or to imprisonment for a term not exceeding three years or to both such fine and imprisonment.

50. Any Islamic bank which contravenes or fails to comply with any provision of this Act or regulations made thereunder for which no penalty is expressly provided shall be guilty of an offence and shall on conviction be liable to a fine not exceeding fifty thousand ringgit.

General
penalty.

51. (1) The Governor of the Central Bank, with the concurrence of the Minister, may compound any offence punishable under this Act by accepting such sum of money as he thinks fit, being not exceeding the amount of the maximum fine to which that person would have been liable if he had been convicted of the offence.

Power of
Governor to
compound

(2) Any moneys paid to the Governor pursuant to the provisions of subsection (1) shall be paid into and form part of the Consolidated Fund.

52. No prosecution in respect of any offence under this Act shall be instituted without the consent in writing of the Public Prosecutor.

Consent of
the Public
Prosecutor.

53. (1) The Central Bank may with the approval of the Minister make such regulations as may be required from time to time for carrying into effect the objects of this Act

Regulations

(2) Without prejudice to the generality of subsection (1), regulations may be made—

- (a) to provide for control by the Central Bank with respect to the acquisition or holding by an Islamic bank of shares of any corporation or the acquisition or development by the bank of any immovable property,

- (b) to provide for control by the Central Bank with respect to an Islamic bank becoming a partner or proprietor of any firm with unlimited liability;
- (c) to provide for control by the Central Bank with respect to the granting of any credit facility to any person for the purpose of financing the acquisition or holding of immovable property, shares and contracts in consumer credit and commodity futures;
- (d) to provide for the declaration by directors of Islamic banks to the board of directors of their respective Islamic banks of the number and description of any shares in any corporation which are held by or in trust for them or of which they have any right to become the holder (whether on payment or not) or in which they have, directly or indirectly, any beneficial interest, and of the nature of their interest as partner, director, manager or agent in any firm or corporation; and
- (e) to provide for the declaration by executive directors, officers and employees of Islamic banks to the respective boards of directors of such Islamic banks or such other person as may be specified in the regulations of the following kinds of interest held by or for any of them or any of their spouses or children:
 - (i) the number and description of any shares in any corporation which are held by or in trust for any such executive director, officer, employee, spouse or child or of which he has any right to become the holder (whether on payment or not) or in which he has, directly or indirectly, any beneficial interest;
 - (ii) the nature of any interest as partner, director, manager or agent in any firm or corporation; and
 - (iii) all other assets

Bank
holidays
1002

54. No Islamic bank shall do any business with the public on any day declared a bank holiday under the provisions of section 57 (1) of the Banking Act 1973.

55. An Islamic bank which is incorporated under the Companies Act 1965 shall be subject to the provisions of that Act as well as to the provisions of this Act, save that where there is any conflict or inconsistency between the provisions of that Act and the provisions of this Act the provisions of this Act shall prevail

Application
of other
laws
Act 125

56. The Minister may, with or without conditions, exempt any Islamic bank from any provision of this Act

Exemption.

PART VIII

CONSEQUENTIAL AMENDMENTS

57. (1) Section 2 of the Banking Act 1973 is amended—

Amendment
of Banking
Act 1973
Act 102

(a) by inserting immediately after the definition of “depositor” the following new definition:

““Islamic bank” means a bank licensed under the Islamic Banking Act 1983;” and

Act 276

(b) by inserting immediately after the words “other licensed bank” in the definitions of “other deposit liabilities”, “sight liabilities” and “time liabilities” the words “, any Islamic bank”.

(2) Section 9 of the Banking Act 1973 is amended by substituting for paragraph (b) of subsection (1) the following:

“(b) no bank shall hereafter be licensed by a name which includes—

(i) any of the words “Central”, “Commonwealth”, “Federal”, “Federation”, “Malaysia”, “Malaysian”, “National”, “Reserve”, or “State”;

(ii) any of the words “Islamic” or “Muslim” or any other words capable of being construed as indicating that the bank carries on Islamic banking business,

either in National Language or in English or in any other language ”

(3) Section 59 of the Banking Act 1973 is amended by deleting the word “and” at the end of paragraph (b) of subsection (1), substituting a semicolon for the full stop at the end of paragraph (c) of that subsection and inserting immediately thereafter the word “and”, and inserting immediately after that paragraph the following new paragraph (d):

“(d) any Islamic bank”.

Amendment
of
Companies
Act 1965
Act 125
Act 276

58. (1) Section 4 of the Companies Act 1965 is amended by inserting immediately after the words “1973” in the definition of “banking corporation” the words “and an Islamic bank as defined in the Islamic Banking Act 1983”

(2) Section 218 of the Companies Act 1965 is amended by substituting for paragraph (j) of subsection (1) the following:

“(j) the company has held a licence under the Banking Act 1973 or the Islamic Banking Act 1983, and that licence has been revoked or has expired and has not been renewed; or”.

Amendment
of the
Central
Bank of
Malaysia
Ordinance
1958
61/58
Act 276

59. (1) Section 2 of the Central Bank of Malaysia Ordinance 1958, which in this section is referred to as “the Ordinance”, is amended—

(a) by inserting immediately before the semicolon at the end of the definition of “bank” the words “or the Islamic Banking Act 1983”;

(b) by inserting immediately after the definition of “Governor” the following new definitions:

“investment account liabilities” in relation to an Islamic bank means the deposit liabilities at that bank in respect of funds placed by a depositor with that bank for a fixed period of time under an agreement to share the profits or losses of that bank on the investment of such funds;

“Islamic bank” means a bank licensed under the Islamic Banking Act 1983; and

ISLAMIC BANKING

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- (c) by inserting immediately after the words "in relation to a bank" in the definition of "other deposit liabilities" the words "other than an Islamic bank" and by inserting immediately after the semicolon at the end of that definition the following words:

"and in relation to an Islamic bank means deposit liabilities at that bank other than savings account, investment account, sight and time liabilities and deposit liabilities from another bank or the Central Bank:".

- (2) Section 37 of the Ordinance is amended—

- (a) by inserting immediately after the words "payable to or by banks" in paragraph (b) of subsection (1) the words "other than Islamic banks";
- (b) by inserting immediately after the words "each bank" in paragraph (c) of subsection (1) the words ", other than an Islamic bank," and by substituting a semicolon for the full stop at the end of that paragraph;
- (c) by inserting immediately after paragraph (c) of subsection (1) the following new paragraph (d):
- "(d) a reserve to be held by each Islamic bank at the Central Bank comprising such amounts expressed as a percentage of each bank's sight, savings account, investment account, time and other deposit liabilities as may be approved by the Minister on the recommendation of the Board, whether denominated in Malaysian or foreign currency"; and
- (d) by inserting immediately after the words "paragraph (c)" in subsection (2) the words "or (d)".

- (3) Section 41 of the Ordinance is amended by substituting for the words "banks or groups of banks" in the first paragraph the words "banks other than Islamic banks or groups of such banks, nor shall it discriminate among Islamic banks or groups of Islamic banks."

- (4) Section 42 of the Ordinance is amended by inserting immediately after the words "Banking Act, 1973" the words "or the Islamic Banking Act 1983".

111 276.

(5) Section 51 of the Ordinance is amended—

(a) by deleting the words “interest charge” in paragraph (a) of subsection (4); and

(b) by deleting the word “interest” in paragraph (b) of subsection (4).

Amendment
of Finance
Companies
Act 1969
Act 6

Act 276

60. Section 2 of the Finance Companies Act 1969 is amended by substituting for the words “to carry on banking business in the Federation” in the definition of “bank” the words “under the Banking Act 1973 or an Islamic bank licensed under the Islamic Banking Act 1983”.

Appendix B

5

LAWS OF MALAYSIA

Act 275

GOVERNMENT INVESTMENT ACT 1983

An Act to confer on the Minister power to receive investments of moneys for a fixed period and to pay dividend thereon.

[]

BE IT ENACTED by the Duli Yang Maha Mulia Seri Paduka Baginda Yang di-Pertuan Agong with the advice and consent of the Dewan Negara and Dewan Rakyat in Parliament assembled, and by the authority of the same, as follows:

1. This Act may be cited as the Government Investment Act 1983. Short title

2. In this Act, unless the context otherwise requires— Interpretation

“investment” means an investment made in accordance with section 3;

“investment certificate” means a receipt in the form of an investment certificate, issued in accordance with section 6;

“Minister” means the Minister charged with the responsibility for finance.

3. (1) The Minister is hereby authorized to receive, on behalf of the Government of Malaysia, at such times and up to such maximum amounts as he may from time to time specify, investments of moneys from any person of a sum of ten thousand ringgit or a multiple of ten thousand ringgit. Power of Minister to receive investments

(2) The total amount of moneys received under subsection (1) not repaid at any one time shall not exceed an amount to be specified from time to time by the Yang di-Pertuan Agong by order published in the *Gazette*.

(3) An order under subsection (2) shall, as soon as possible after its publication, be laid before the Dewan Rakyat.

Application
of moneys

4. The moneys received under section 3 (1) shall be applied, and are hereby appropriated, to the following purposes:

(a) repayment of the moneys so received, to such extent as the Minister may determine;

(b) payment, with the prior approval of the Dewan Rakyat signified by resolution, into the Development Fund specified in the Second Schedule to the Financial Procedure Act 1957, for the purposes of that Fund.

Act 61.

Period of
investment.

5. Any person making an investment under section 3 (1) shall thereupon declare the period for which the investment is made, which shall be one full year or more; and at the end of that period the money invested shall be repaid in the manner hereinafter provided.

Investment
certificate.

6. The Minister shall issue a receipt in the form of an investment certificate in the Schedule for every investment made.

Transfer of
investment
certificate

7. Investment certificates shall be transferable by endorsement and delivery.

Dividend.

8. (1) No interest shall be paid on investments but there shall instead be paid dividends in accordance with this section.

(2) The Minister shall from time to time, by order published in the *Gazette*, declare the rates of dividends to be paid on investments.

(3) Dividends on each investment shall become due annually on the anniversary of the date of its making and shall be paid at the Federal Treasury to the holder of the investment certificate relating to the investment on presentation of the investment certificate to the Minister, who shall endorse, or cause to be endorsed, particulars of the amount of dividend paid and the date of payment on the back of the investment certificate; and such endorsement shall be conclusive evidence that the dividend specified in the endorsement has been paid.

(4) No dividend shall be due or payable on any investment after the period for which the investment was made.

9. (1) An investment shall be repaid on maturity to the holder of the investment certificate relating to the investment on his tendering to the Minister the investment certificate.

Repayment
of
investment.

(2) No investment shall be repaid except upon surrender of the investment certificate relating thereto to the Minister for cancellation.

10. The moneys represented by investment certificates, and the dividends thereon, are hereby charged upon and shall be payable out of the Consolidated Fund.

Investments
and
dividends
to be a
charge on
Consoli-
dated Fund.

11. No stamp duty shall be leviable or payable on any investment certificate or on the transfer thereof.

Investment
certificates
to be free
of stamp
duty.

12. The Minister may, by notification in the *Gazette*, delegate to the Accountant General or the Central Bank of Malaysia any or all of the powers or duties conferred upon him by this Act.

Delegation
by Minister
of his
powers
and duties.

13. Any person who forges or alters any investment certificate or any word, figure, marks, sign, signature, or facsimile upon or attached to any investment certificate, or who offers or utters or disposes of any investment certificate knowing the same to be forged or altered shall on conviction be liable to imprisonment for a term not exceeding fifteen years.

Offences.

[Schedule]

8

ACT 275

SCHEDULE

(Section 6)

GOVERNMENT INVESTMENT ACT 1983

INVESTMENT CERTIFICATE

The Minister of Finance hereby acknowledges the investment
in the Federal Treasury of the sum of \$.....
(say... ..)
by .. of
for a period of.....years.

Dated this.....day of.....19.....

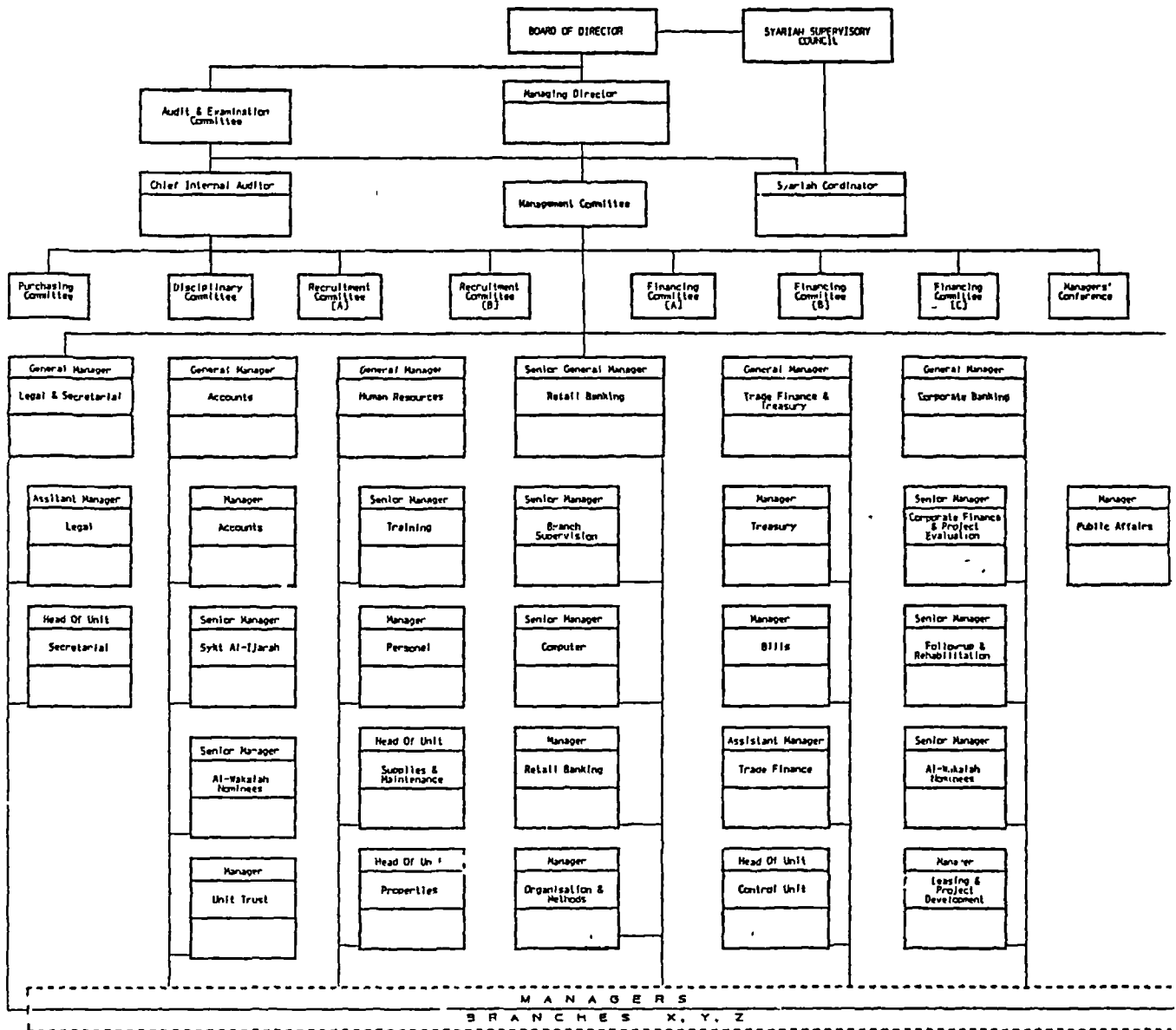
.....
(Signature)
Minister of Finance

DICETAK OLEH JABATAN PERCETAKAAN NEGARA, KUALA LUMPUR
DENGAN PERINTAI PADA 10118 MAC 1983

Harga: 50 sen

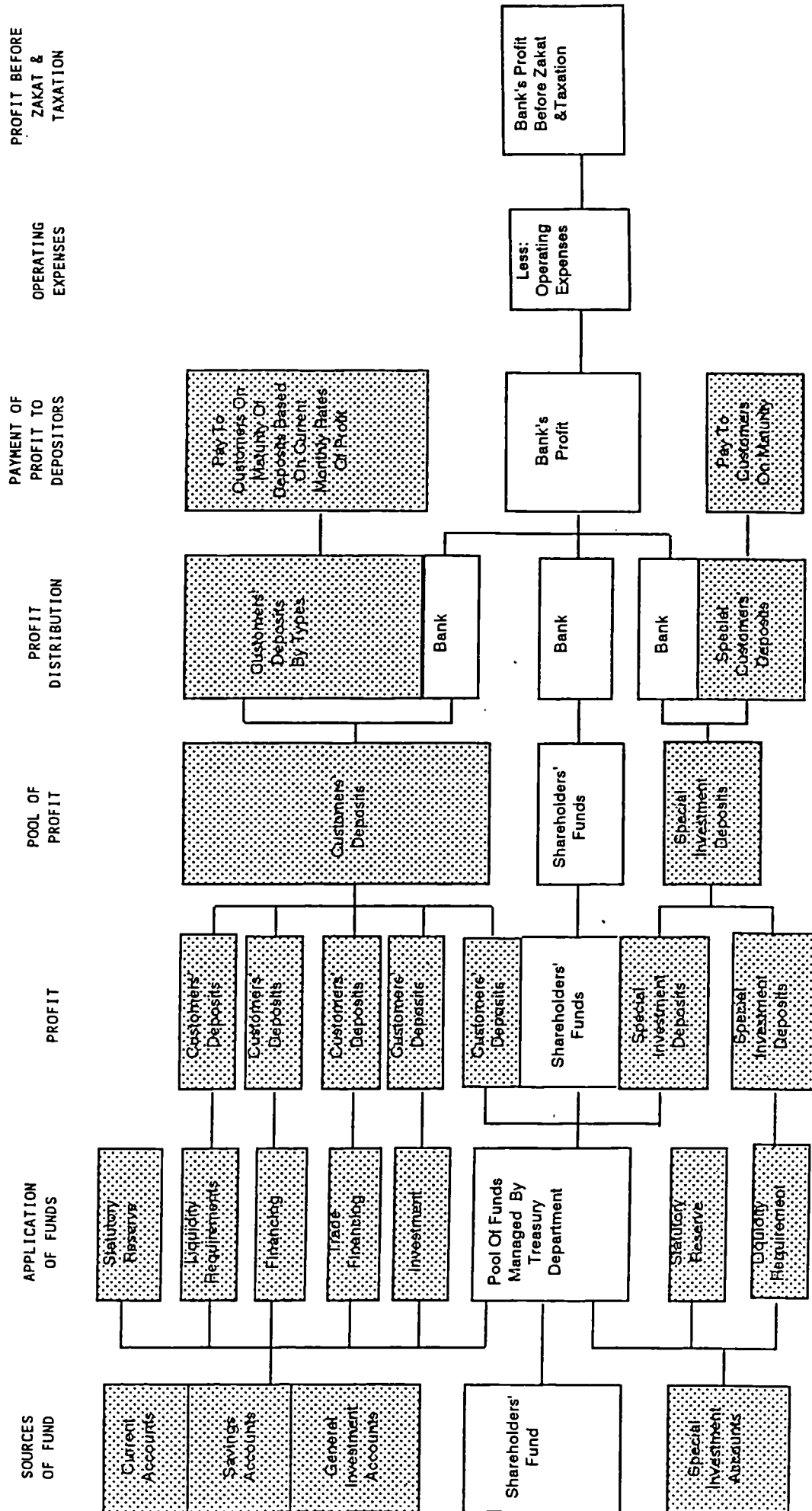
Appendix C

BIMB Organizational Structure



BIMB- Sources and Uses of Funds

Appendix D



Appendix E

BIMB - Distribution of Profits

E. PROFITABILITY ACCOUNTING FOR THE WHOLE BANK

XII. PROFITS ATTRIBUTABLE TO DEPOSITORS AND BANK

12.1 The tasks of consolidating all the relevant figures for profitability accounting from Branches and the relevant Departments in the Head Office and computing the final profit figures for the whole Bank belong to the Accounting Division.

12.2 There are two levels of consolidated profitability accounting, namely

- (a) profitability for payment of profits to the Depositors
- (b) profitability of the Bank

12.3 The exercise is to be done monthly for month-end positions.

12.4 For computing profitability for the purpose of payment of profits to the Depositors, use the Format given in Appendix II after substituting the word Branch with the word Bank above Columns 9-10. Thereafter execute the following steps:-

Step 1 -- Consolidate the average daily balances of various types of deposits for the month for all Branches and enter the

consolidated figures in the appropriate places in Column 1.

Step 2 -- Multiply Column 1 by Column 2 and fill in the products in the appropriate places in Column 3.

Step 3 -- Consolidate for all Branches

(a) Month-end balance in the Branch Financing and Investment Income Account

(b) Month-end balances in the Branch Foreign Exchange Income Account

and enter the consolidated figure in the bottom line of Column 4, and further distribute this total figure among various types of deposits using the weighted proportions in Column 3.

Step 4 -- Apportion the profit figures for various types of deposits in Column 4 between Depositors and Bank by using the proportions in Column 5 and Column 8 respectively and enter the products in Column 6 and Column 9 respectively.

Step 5 -- Calculate the percentage rates of profits for the Depositors and Bank for various types of deposits through dividing the figures in Column 6 and Column 9 respectively by the average daily balances for the month in Column 1 and subsequently multiply the resultant figures by 12 and enter the products in Column 7 and Column 10 respectively.

Step 6 -- For every rate of profit for the respective type of deposits in Column 7 calculate the 12-month moving average for the latest twelve months (including the month in question).

12.5 It is to be emphasised that the final rates of profits obtained in Step 6 above are the relevant rates of profits that the Bank will pay all Depositors for their deposits throughout all its Branches. These rates of profits will be current from the 16th day of the following month until the 15th day of the month after.

12.6 It is the duty of the Accounting Division to have these rates computed accurately and to inform all Branches before the 16th day in the relevant month.

12.7 Branches are to post these rates on the Notice Board for Rates of Profits during the relevant dates, that is from 16th day of the relevant month until the 15th day of the following month.

XIII. PROFITS OF THE BANK

13.1 For computing the profits of the Bank for the month in question the following additional steps will have to be executed:-

Step 1 -- Take the figure at the bottom of Column 9 in the Format above.

Step 2 -- Consolidate the month-end balances in the Fees and Commissions Accounts of all Branches.

Step 3 -- Consolidate the monthly profits of the Shareholders' Funds by adding the following:-

- (a) Month-end balance in the Shareholders' Funds Profit Account (Treasury Department)
- (b) Month-end balance in the Shareholders' Funds Profit Account (Investment Management Department)
- (c) Month-end balance in the Shareholders' Funds Dividend Account (Accounting Division)

- Step 4 -- Obtain the Bank's Gross Profits by adding the results from Step 1, Step 2, and Step 3.
- Step 5 -- Calculate the Bank's Total Operational Expenditures by consolidating the operational expenditures of all Branches and the Head Office.
- Step 6 -- The Bank's Gross Profits (Step 4) less the Bank's Total Operational Expenditures (Step 5) gives the Bank's Net Profit for the month.

DISTRIBUTION OF GROSS REVENUES ATTRIBUTABLE TO THE DEPOSITORS AND THE BANK
FOR THE MONTH OF _____

Type Of Deposits	Monthly Average Daily Balances (\$)	Weight	Weighted Proportion Of Profits	Distribution Of Profits (\$)	Depositors			Bank		
					Proportion	Profits (\$)	Return % p.a.	Proportion	Profits (\$)	Return % p.a.
	1	2	3	4	5	6	7	8	9	10
Current Accounts Savings Accounts Other Deposits Investment Accounts: 1 month 3 months 6 months 9 months 12 months 15 months 18 months 24 months 36 months 48 months 60 months above 60 months		0.70 1.00 0.70			0.25 0.50 -			0.75 0.50 1.00		
		0.80 0.85 0.90 0.95 1.00 1.05 1.10 1.15 1.20 1.25 1.30 1.35			0.70 0.70 0.70 0.70 0.70 0.70 0.70 0.70 0.70 0.70 0.70 0.70			0.30 0.30 0.30 0.30 0.30 0.30 0.30 0.30 0.30 0.30 0.30 0.30		
	Total									

Appendix F

Sum of Digits

Sum of Year's Digits Technique (SOD)

Repayment Schedule

$$R_1 = \frac{n}{(SOD)}P$$

$$R_2 = \frac{n-1}{(SOD)}P$$

$$R_n = \frac{1}{(SOD)}P$$

where

$$SOD = n + (n-1) + (n-2) \dots + 1 = \frac{n(n+1)}{2}$$

n = the duration of financing

SOD = the sum of all the year's digits corresponding to that duration.

P = selling price, (cost-price + profit margin)

Hence if

$$n = 4 \text{ years}$$

$$P = \$10000$$

$$SOD = 4 + 3 + 2 + 1 = \frac{4 \cdot 5}{2} = 10$$

$$R_1 = \$4000$$

$$R_2 = \$3000$$

$$R_4 = \$1000$$

Appendix G

**ANALYTICAL DIVISION
FACULTY OF ECONOMICS & ADMINISTRATION
UNIVERSITY OF MALAYA**

BANK ISLAM: DEPOSITORS QUESTIONNAIRE

INTRODUCTION

Assalamualaikum

We are conducting a survey on banks in Malaysia and would like to know your opinion. We assure that all information you give will be kept confidential and no name will be recorded.

For office use only				
Interviewer: Tick (✓)				
1. Day:	Monday	<input type="checkbox"/>	Tuesday	<input type="checkbox"/>
	Wednesday	<input type="checkbox"/>	Thursday	<input type="checkbox"/>
	Friday	<input type="checkbox"/>	Saturday	<input type="checkbox"/>
2. Time of Interview:	Fromto.....			
3. Date/...../1991				
4. Name of Interviewer:			
5. Checked by:			
6. Date:.....				

PART ONE

ACCOUNT BACKGROUND

1. When did you open an account at Bank Islam?

- | | | | |
|------|----------------------------|------|----------------------------|
| 1983 | <input type="checkbox"/> 1 | 1988 | <input type="checkbox"/> 6 |
| 1984 | <input type="checkbox"/> 2 | 1989 | <input type="checkbox"/> 7 |
| 1985 | <input type="checkbox"/> 3 | 1990 | <input type="checkbox"/> 8 |
| 1986 | <input type="checkbox"/> 4 | 1991 | <input type="checkbox"/> 9 |
| 1987 | <input type="checkbox"/> 5 | | |

2. Type of account you hold at Bank Islam (tick more than once where appropriate)

Savings Account

Current Account

General Investment

☐ 1

☐ 2

☐ 3

3. Do you also hold accounts in other banks now?

Yes

☐ 1

(If Yes, go to PART A)

No

☐ 2

(If No, go to PART B)

PART A

(To be answered by depositors who also have accounts in other banks)

(i) In which bank do you also have an account?

(tick the bank you do most business with)

- | | |
|------------------------|----------------------------|
| Bank Bumiputra | <input type="checkbox"/> 1 |
| Bank Simpanan Nasional | <input type="checkbox"/> 2 |
| Malayan Banking | <input type="checkbox"/> 3 |
| UMBC | <input type="checkbox"/> 4 |
| Public Bank | <input type="checkbox"/> 5 |
| Others | <input type="checkbox"/> 6 |

(ii) Type of account you hold at that bank

(tick more than one if appropriate)

Savings Account

Current Account

Fixed Deposit

☐ 1

☐ 2

☐ 3

(iii) Please tick 3 MAIN REASONS why you also keep accounts in other banks

(Choose 3 only)

- | | |
|-----------------------------------|-----------------------------|
| ATM facilities available | <input type="checkbox"/> 1 |
| Well known bank | <input type="checkbox"/> 2 |
| It has many branches | <input type="checkbox"/> 3 |
| Near workplace | <input type="checkbox"/> 4 |
| Near to where I shop | <input type="checkbox"/> 5 |
| Near my home | <input type="checkbox"/> 6 |
| Fast and efficient service | <input type="checkbox"/> 7 |
| To apply for housing loan | <input type="checkbox"/> 8 |
| Encouragement of friends & family | <input type="checkbox"/> 9 |
| Higher interests on savings | <input type="checkbox"/> 10 |
| Other (please specify) | <input type="checkbox"/> 11 |

.....

(iv) In which bank do you have more savings?

Bank Islam	<input type="checkbox"/> 1	Commercial Bank	<input type="checkbox"/> 2
------------	----------------------------	-----------------	----------------------------

(v) In which bank do you frequently go or have more business done?

Bank Islam	<input type="checkbox"/> 1	Commercial Bank	<input type="checkbox"/> 2
------------	----------------------------	-----------------	----------------------------

PLEASE GO TO PART TWO

PART B

(For depositors who have accounts only at Bank Islam)

1. Have you ever saved in commercial banks before?

Yes	<input type="checkbox"/> 1	No	<input type="checkbox"/> 2
-----	----------------------------	----	----------------------------

2. If Yes,

2.1 In which bank did you save before?
(tick your main bank only)

- | | |
|------------------------|----------------------------|
| Bank Bumiputra | <input type="checkbox"/> 1 |
| Bank Simpanan Nasional | <input type="checkbox"/> 2 |
| Malayan Banking | <input type="checkbox"/> 3 |
| UMBC | <input type="checkbox"/> 4 |
| Public Bank | <input type="checkbox"/> 5 |
| Other than the above | <input type="checkbox"/> 6 |

2.2 From the list below, please tick 3 MAIN REASONS why you kept accounts in commercial banks before?

3 reasons only

- | | |
|-----------------------------------|-----------------------------|
| ATM facilities available | <input type="checkbox"/> 1 |
| Well known bank | <input type="checkbox"/> 2 |
| Near workplace | <input type="checkbox"/> 3 |
| Near my home | <input type="checkbox"/> 4 |
| It has many branches | <input type="checkbox"/> 5 |
| Fast and efficient service | <input type="checkbox"/> 6 |
| Salary paid here | <input type="checkbox"/> 7 |
| Encouragement of friends & family | <input type="checkbox"/> 8 |
| Higher interest on savings | <input type="checkbox"/> 9 |
| Got a loan from that bank | <input type="checkbox"/> 10 |
| No Bank Islam branch | <input type="checkbox"/> 11 |
| Others (please specify) | <input type="checkbox"/> 12 |

.....

PART TWO

A. From the list below, tick (✓) to show how each has influenced you to open an account at Bank Islam

Factor	Degree of Influence				
	None	Little	Quite Strong	Strong	Strongest
	1	2	3	4	5
1. Encouragement of friends	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Bank Islam Opening Publicity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Distance from workplace	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. No interest paid on savings	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. No interest on loans	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6 Profit sharing Investments	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7 Distance from home	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8. Profits paid on savings	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9 Runs on Islamic Principles	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10 Parking Facilities Available	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
11. Near Public Transport	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
12 Types of Loans offered	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
13 Opportunity to get a loan	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
14 The number of branches available	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

B. 1. Bank Islam now pays profits on your savings account. Would you close your account at Bank Islam if this rate of profit is lower than (cannot compete with) interest rates on savings in other banks?

Yes ☐ 1 No ☐ 2

2. If this Bank Islam branch has to close, which bank would you next choose?

(1) another bank in this area ☐ 1

(2) another Bank Islam branch even if it is quite far ☐ 2

3. Have you secured any loan from Bank Islam?

Yes

☐ 1

No

☐ 2

4. How far is this Bank Islam branch from

(i) your workplace ?

0-2 miles

☐ 1

3-5 miles

☐ 2

more than 5 miles

☐ 3

(ii) your home

0-2 miles

☐ 1

3-5 miles

☐ 2

more than 5 miles

☐ 3

PART THREE

A. From the list below please tick (✓) for the services which you know are provided by Bank Islam

Table A.
SERVICES OF BANK ISLAM

1. DEPOSITS

1.1. Savings Account

☐ 1

1.2. Current Account

☐ 2

1.3. General Investment Account

☐ 3

1.4. Special Investment Account

☐ 4

(2) LOAN/FINANCING

2.1. Al-Bai Bithamin Ajil

☐ 5

2.2. Al-Ijarah

☐ 6

2.3. Al-Musharakah (Profit and Loss Sharing)

☐ 7

2.4. Al-Mudharabah (Trustee Profit Sharing)

☐ 8

2.5. Al-Murabaha (Cost Price + Markup Sale)

☐ 9

2.6. Al-Qardul Hasan YPEIM (interest-free short loan)

☐ 10

(3) OTHERS

3.1. Foreign Exchange Buying & Selling

☐ 11

3.2. Travellers' Cheque

☐ 12

3.3. Remittances and Transfers

☐ 13

B. 1. Have you heard of the word 'RIBA'?

Yes ☐ 1 No ☐ 2

2. If Yes, do you think Bank Interest is the same as 'riba'?

Yes ☐ 1 No ☐ 2 Not sure ☐ 3 Don't know ☐ 4

3. Would you agree if a commercial bank (not Bank Islam) opens a special counter to provide bank services according to Islamic principles?

Disagree ☐ 1 Agree ☐ 3 No opinion ☐ 5
Quite Disagree ☐ 2 Quite Agree ☐ 4

Please give your reason

PART FOUR

Below are statements which might describe this BANK ISLAM branch.

Please circle the correct number to show how much you agree or disagree with each statement as follows.

- | | |
|----------------------|-------------------|
| 1. strongly disagree | 4. no opinion |
| 2. disagree | 5. quite agree |
| 3. somewhat disagree | 6. agree |
| | 7. strongly agree |

	Strongly disagree	Quite disagree	disagree	no opinion	quite agree	strongly agree	agree
	1	2	3	4	5	6	7
A.							
1 well known bank	1	2	3	4	5	6	7
2 many branches	1	2	3	4	5	6	7
3. near to workplace	1	2	3	4	5	6	7
4 near to my home	1	2	3	4	5	6	7
5 near to public transport	1	2	3	4	5	6	7
6 parking available	1	2	3	4	5	6	7
7 easy to reach	1	2	3	4	5	6	7
B							
1 enough bank services provided	1	2	3	4	5	6	7
2 satisfied with profits on savings	1	2	3	4	5	6	7
3 loans that I want are available	1	2	3	4	5	6	7
4 expensive loan payment	1	2	3	4	5	6	7
C.							
1 many counters opened at peak hours	1	2	3	4	5	6	7
2 courteous counter services	1	2	3	4	5	6	7
3 fast and efficient counter service	1	2	3	4	5	6	7
4 bank officers ready to help	1	2	3	4	5	6	7

PART FIVE

Listed below are services that can be provided by Bank Islam. Please tick () to show how much YOU NEED each of these services.

Service	Do not Need 1	No Opinion 2	Quite Needed 3	Need 4
1 ATM	-	-	-	-
2. Bank Islam pays zakat on savings on your behalf	-	-	-	-
3 piggy banks for children	-	-	-	-
4 housing loan/financing	-	-	-	-
5 interest free short term loans	-	-	-	-
6 separate counters for women	-	-	-	-

PART SIX

We need some information about yourself to enable us to make meaningful interpretation of the data obtained. All information will be kept confidential and no names will be recorded.

Please tick (✓) in the suitable box for each question.

- | | | | | |
|-------------------|----------------------|----------------------------|----------------------------|----------------------------|
| 1. Sex | Male | <input type="checkbox"/> 1 | Female | <input type="checkbox"/> 2 |
| 2. Age | 18 - 25 years | | <input type="checkbox"/> 1 | |
| | 26 - 33 | | <input type="checkbox"/> 2 | |
| | 34 - 41 | | <input type="checkbox"/> 3 | |
| | 42 - 49 | | <input type="checkbox"/> 4 | |
| | 50 and over | | <input type="checkbox"/> 5 | |
| 3. Race | Malay | <input type="checkbox"/> 1 | Indian | <input type="checkbox"/> 2 |
| | Chinese | <input type="checkbox"/> 3 | Others | <input type="checkbox"/> 4 |
| 4. Religion | Islam | <input type="checkbox"/> 1 | Others | <input type="checkbox"/> 2 |
| 5. Marital status | married | <input type="checkbox"/> 1 | single | <input type="checkbox"/> 2 |
| | other than the above | | <input type="checkbox"/> 3 | |

6. Your highest level of education

- | | |
|---------------------|----------------------------|
| Primary School | <input type="checkbox"/> 1 |
| Secondary School | <input type="checkbox"/> 2 |
| College Diploma | <input type="checkbox"/> 3 |
| University | <input type="checkbox"/> 4 |
| No Formal Education | <input type="checkbox"/> 5 |

7. Your Job (if currently employed)

- | | |
|-----------------------------------|-----------------------------|
| Professional | <input type="checkbox"/> 1 |
| Administrative/Managerial Officer | <input type="checkbox"/> 2 |
| Executive Officer | <input type="checkbox"/> 3 |
| Lecturer | <input type="checkbox"/> 4 |
| Teacher | <input type="checkbox"/> 5 |
| Clerk | <input type="checkbox"/> 6 |
| Police or Army | <input type="checkbox"/> 7 |
| Typist | <input type="checkbox"/> 8 |
| Nurse | <input type="checkbox"/> 9 |
| Technician | <input type="checkbox"/> 10 |
| Own business | <input type="checkbox"/> 11 |
| Self-employed | <input type="checkbox"/> 12 |
| Labourer/Unskilled worker | <input type="checkbox"/> 13 |
| Others (please specify) | <input type="checkbox"/> 14 |
-

8. In which sector do you work?

- | | |
|--------------------------|----------------------------|
| government/public sector | <input type="checkbox"/> 1 |
| private sector | <input type="checkbox"/> 2 |
| self-employed | <input type="checkbox"/> 3 |
| semi-government agency | <input type="checkbox"/> 4 |
| charitable organisation | <input type="checkbox"/> 5 |
| others (please specify) | <input type="checkbox"/> 6 |
-

9. If you are not working. Are you a

- | | |
|-------------------------|----------------------------|
| housewife/homemaker | <input type="checkbox"/> 1 |
| student | <input type="checkbox"/> 2 |
| pensioner | <input type="checkbox"/> 3 |
| unemployed | <input type="checkbox"/> 4 |
| others (please specify) | <input type="checkbox"/> 5 |
-

10. Do you also save in these institutions?
(Please tick more than one if appropriate)

Co-operative	<input type="checkbox"/> 1
Tabung Haji	<input type="checkbox"/> 2

11. Do you invest in Amanah Saham Nasional?

Yes	<input type="checkbox"/> 1	No	<input type="checkbox"/> 2
-----	----------------------------	----	----------------------------

12. If you have an income, how much do you earn monthly? (fixed income)

less than \$400	<input type="checkbox"/> 1
\$400 - \$700	<input type="checkbox"/> 2
\$701 - \$1000	<input type="checkbox"/> 3
\$1001 - \$1400	<input type="checkbox"/> 4
\$1401 - \$1700	<input type="checkbox"/> 5
\$1701 - \$2100	<input type="checkbox"/> 6
\$2101 - \$2500	<input type="checkbox"/> 7
\$2501 - \$3500	<input type="checkbox"/> 8
\$3501 - \$5000	<input type="checkbox"/> 9
More than \$5000	<input type="checkbox"/> 10

13. Please give your comments and suggestions to improve the services of bank Islam.

a. Comments

.....
.....

b. Suggestions

.....
.....

THANK YOU FOR YOUR CO-OPERATION

Appendix H

Conventional Bank Depositors' Questionnaire

BAHAGIAN EKONOMI ANALISA,
FAKULTI EKONOMI DAN PENTABDIRAN
UNIVERSITI MALAYA.

PELANGGAN BANK PERDAGANGAN (BUKAN BANK ISLAM)
COMMERCIAL BANK CUSTOMERS (NOT BANK ISLAM)

PENGENALAN

Introduction

Assalamualaikum/Selamat Pagi/Selamat Petang
Assalamualaikum/good morning/good afternoon

Kami sedang menjalankan kajian tentang bank di Malaysia. Boleh saya bertanya:

- 1) Selain dari di bank ini adakah anda mempunyai akaun di bank lain. Jika tidak bolehkah tuan meluangkan sedikit masa untuk menjawab soalselidik ini.

Jika Ya, adakah tuan mempunyai akaun di Bank Islam?

Jika Ya, minta maaf kami ingin menemuduga mereka yang bukan pelanggan Bank Islam sahaja. Terima kasih.

Jika tidak, bolehkan tuan meluangkan beberapa minit untuk menjawab soalselidik ini.

Segala maklumat ini adalah dirahsiakan dan apabila dikod untuk analisis komputer, tiada nama akan direkodkan.

We are conducting a Survey on banks in Malaysia. May I ask:

- 1) Besides this bank, do you have an account at Bank Islam?

If yes, sorry we would like to interview only non-customers of Bank Islam. If no, can you spare a few minutes to answer this questionnaire. All information will be kept confidential and no names will be recorded when information are coded for computer analysis.

Untuk Kegunaan Pejabat Sahaja	
Petugas Tandakan (✓)	
1. Nama Bank	Bank Bumiputra <input type="checkbox"/> Public Bank <input checked="" type="checkbox"/> Malayan Banking <input type="checkbox"/> UMBC <input type="checkbox"/>
2. Hari	Isnin <input type="checkbox"/> Selasa <input type="checkbox"/> Rabu <input type="checkbox"/> Khamis <input type="checkbox"/> Jumaat <input checked="" type="checkbox"/> Sabtu <input type="checkbox"/>
3. Masa Temuduga	Jam 10.00 hingga 10.20
4. Tarikh	27 / 3 / 1991
5. Responden	Muslim <input checked="" type="checkbox"/> Non Muslim <input type="checkbox"/>
6. Nama Petugas	W. Abd. Azis
7. Disemak oleh	E. K.
Tarikh	30.3.91

BAHAGIAN 1

Dari senarai di bawah, tandakan (✓) untuk menunjukkan sejauh mana tiap-tiap faktor mempengaruhi anda untuk membuka akaun di bank ini.

From the list below, tick (✓), to show how each factor influences you to open an account in this bank

Peringkat Pengaruh

Degree of influence

1 - Tiada langsung

1 - none

2 - sedikit

2 - a little

3 - sederhana (lebih kurang)

3 - average (more or less)

4 - kuat

4 - strong

5 - amat kuat

5 - strongest

Faktor Factor	Peringkat Pengaruh Degree of Influence				
	Tiada Langsung	Sedikit	Sederhana (Lebih kurang)	Kuat	Amat Kuat
	None	A Little	More or Less	Strong	Strongest
	1	2	3	4	5
1 Arahkan Majikan Employer's Direction	✓				
2 Dorongan keluarga dan kawan-kawan Encouragement of friends and relatives	✓				
3 Publisiti melalui iklan bank Publicity through bank advertisements	✓				
4 Jarak bank ini dengan tempat kerja Distance of bank from workplace					✓
5 Jarak bank ini dengan tempat tinggal Distance of bank from home	✓				
6 Jarak bank ini dengan pusat membeli-belah Distance of bank from shopping-centre				✓	
7 Adanya kemudahan meletak kereta Availability of parking spaces				✓	
8 Kemudahan pengangkutan awam Convenience of public transport				✓	
9 Perkhidmatan yang cepat dan cekap Fast and efficient service					
10 Adanya kemudahan ATM Availability of ATM facility			✓		
11 Tingginya kadar faedah atas simpanan The rate of interest on savings	✓				
12 Kemudahan mendapat pinjaman Ease of getting loan	✓				
13 Jenis pinjaman yang disediakan Types of loans available	✓				
14 Banyaknya cawangan di seluruh negara Availability of branches all over the country				✓	
15 Bank yang terkenal a well known bank	✓				

1 1

1 2

1 3

5 4

1 5

4 6

1 7

1 8

7 9

3 10

1 11

1 12

1 13

4 14

1 15

Di bawah ini ialah kenyataan tentang ciri-ciri yang mungkin ada pada BANK ANDA

Below are a few statements which might describe YOUR BANK

Sila bulatkan angka yang sesuai untuk menunjukkan sejauh mana anda bersetuju atau tidak bersetuju dengan setiap kenyataan tersebut seperti berikut

Please circle the correct number to show how much you agree or disagree with each statement as follows:

LOKASI LOCATION	Tidak Setuju Sama Sekali Strongly disagree	Tidak setuju disagree	Kurang setuju somewhat disagree	Tiada Pendirian No Opinion	Agak setuju Quite agree	Setuju agree	Bangat setuju Strongly agree	
	1	2	3	4	5	6	7	
1 Dekat dengan tempat saya bekerja <i>Near my workplace</i>	1	2	3	4	5	6	7	7 26
2 Dekat dengan tempat saya tinggal <i>Near my home</i>	1	2	3	4	5	6	7	1 27
3 Dekat dengan pusat membeli belah <i>near shopping centre</i>	1	2	3	4	5	6	7	6 28
4 Terdapat kemudahan meletak kereta di sekitar kawasan bank <i>Parking facilities available near the bank</i>	1	2	3	4	5	6	7	6 29
5 Mudah untuk sampai <i>easy to reach</i>	1	2	3	4	5	6	7	7 30
6 Dekat dengan kemudahan pengangkutan awam <i>Near to public transport facilities</i>	1	2	3	4	5	6	7	6 31
PERKHIDMATAN BANK BANK SERVICES								
1 Cukup perkhidmatan bank disediakan <i>Enough bank services provided</i>	1	2	3	4	5	6	7	4 32
2 Kadar faedah atas simpanan cukup memuaskan <i>Most satisfied with rate in interest on savings</i>	1	2	3	4	5	6	7	5 33
3 Kadar faedah atas pinjaman terlalu tinggi <i>Rate of interest on loans is too high</i>	1	2	3	4	5	6	7	6 34
4 banyak jenis pinjaman disediakan <i>many types of loans offered</i>	1	2	3	4	5	6	7	4 35
5 terdapat kemudahan ATM <i>ATM facility available</i>	1	2	3	4	5	6	7	7 36
6 Banyak kaunter di buka bila pelanggan ramai <i>Many counters opened during peak hours</i>	1	2	3	4	5	6	7	6 37
7 Terdapat kaunter pertanyaan <i>Enquiries counter available</i>	1	2	3	4	5	6	7	6 38
8 Perkhidmatan Kaunter bersopan-santun <i>Courteous counter services</i>	1	2	3	4	5	6	7	6 39
9 Perkhidmatan kaunter cepat dan cekap <i>Fast and efficient counter services</i>	1	2	3	4	5	6	7	5 40
10 Pegawai bank bersedia membantu pelanggan <i>Bank officers ready to help customers</i>	1	2	3	4	5	6	7	6 41
1 Pegawai bank sukar ditemui <i>Difficult to meet bank officers</i>	1	2	3	4	5	6	7	4 42
2 Mudah mendapat pinjaman <i>easy to get loans</i>	1	2	3	4	5	6	7	4 43

BAHAGIAN 3

Pada masa ini selain dari bank perdagangan biasa terdapat sebuah Bank Islam di Malaysia
Besides the commercial banks, there is an Islamic Bank in Malaysia today

Dalam Jadual A di bawah tandakan (✓) pada perkhidmatan yang ANDA TAHU ada disediakan oleh BANK ISLAM MALAYSIA BERHAD

In TABLE A below please tick (✓) for the service which YOU KNOW are provided by BANK ISLAM MALAYSIA BERHAD

JADUAL A
TABLE A

PERKHIDMATAN BANK ISLAM MALAYSIA
BANK ISLAM MALAYSIA BERHAD SERVICES

1. DEPOSIT (SIMPANAN)
DEPOSITS (SAVING)

1 1 Akaun Simpanan
Saving Account

☒ 1

☐ 44

Akaun Semasa
Current Account

☐ 2

☐ 45

Akaun Pelaburan Am
General Investment Account

☐ 3

☐ 46

Akaun Pelaburan Khas
Special Investment Account

☐ 4

☐ 47

Peti Simpanan Berkunci
Safe Deposit Box

☐ 5

☐ 48

2. PINJAMAN/PEMBIAYAAN
LOANS/FINANCING

2.1 Pinjaman Bertempoh
Terms Loans

2 1 1 Al-Mudharabah
Trustee Profit-Sharing

☐ 6

☐ 49

2 1 2 Al-Musarakah (Perkongsian Untung-Rugi)
Profit and Loss Sharing

☐ 7

☐ 50

2 1 3 Al-Ijarah (Sewaan)
Leasing

☐ 8

☐ 51

2 1 4 Al-Murabahah (Jualbeli Harga Tambah)
Cost Price + Markup Sale

☐ 9

☐ 52

2 1 5 Al-Bai Bithamin Ajil (Jualbeli Harga Tangguh)
Deferred Payment Sale

☐ 10

☐ 53

2 1 6 Al-Qardhul-Hasan YPEIM (Pinjaman Jangka Pendek Tanpa Faedah)
Interest Free Credit (Short term)

☐ 11

☐ 54

2.2 Pembiayaan Perdagangan
Trade Financing

2 2 1 Surat Kredit
Letter of Credit

☐ 12

☐ 55

2 2 2 Surat Jaminan
Letter of Guarantee

☐ 13

☐ 56

2 3 Lain-Lain
Other

- 2 3 1 Kiriman dan Pindahan Wang ☐ 14
Remittances and Transfers
- 2 3 2 Jualbeli Tukaran Wang Asing ☐ 15
Foreign Exchange Sale + Purchase
- 2 3 3 Cek Kembara' ☐ 16
Travellers' Cheque
- 2 3 4 Pengurusan Pelaburan/Portfolio ☐ 17
Portfolio/Investment Management

☐ 57
☐ 58
☐ 59
☐ 60

5 1 Dari manakah anda mendapat tahu tentang perkhidmatan di atas? Adakah dari
Where did you get information about the above services? Did you get it from

- Risalah Bank Islam ☐ 1 rakan/keluarga ☒ 4
Bank Islam Brochure friends/family
- akbar dan majalah ☐ 2 seminar ☐ 5
Newspaper and magazine seminar
- pelajaran di sekolah/university ☐ 3 radio and T.V ☐ 6
lessons in school/university Radio and T V

☐ 61

5 2 Adakah anda berminat untuk mengetahui dengan lebih lanjut lagi tentang perkhidmatan di Bank Islam?
Are you interested to know more about services at Bank Islam?

- Ya ☒ 1 Tidak ☐ 2
Yes No

☐ 62

5 3 Dalam senarai di bawah tandakan 3 sebab utama anda tidak membuka akaun di Bank Islam
From the list below tick 3 main reasons why you did not open an account at Bank Islam

tandakan 3 sebab sahaja
tick 3 reason only

- majikan membayar gaji di bank ini ☐ 1
employer pays your salary at this bank
- tidak berminat ☐ 2
non interested
- tidak tahu jenis perkhidmatan yang disediakan ☒ 3
don't know the types of services offered
- perkhidmatannya lambat dan kurang cekap ☒ 4
slow and inefficient service
- tiada kemudahan ATM ☐ 5
no ATM Facilities
- kadar pulangan atas simpanan rendah ☐ 6
low rate of return on savings
- tidak menyediakan pinjaman yang saya inginkan ☐ 7
does not provide the loan that I want
- tidak berjaya mendapat pinjaman di Bank Islam ☐ 8
unsuccessful in getting a loan at Bank Islam
- kadar bayaran pinjamannya mahal ☐ 9
expensive rate of payment on its loans
- tidak banyak cawangan ☒ 10
not many branches
- lain-lain (nyatakan) ☐ 11
other (please specify)

☐ 63
☐ 64
☐ 65

BAHAGIAN 4

BUTIR DIRI

Kami memerlukan beberapa maklumat tentang diri anda untuk membuat penaksiran yang bermakna bagi data yang telah kami perolehi. Segala maklumat ini adalah dirahsiakan dan apabila dikod untuk analisis komputer, tiada nama akan direkodkan.

We need some information about yourself to enable us to make meaningful interpretation of the data obtained.

All information will be kept confidential and no names will be recorded when information are coded for computer analysis.

Sila tandakan (☒) dalam kotak yang bersesuaian bagi tiap-tiap soalan di bawah.

- | | | | | | | | |
|---|--|--|---------------------------------------|--------------------------|---------------------------------------|----------------------------|----------------------------|
| 1 | Jantina
Sex | Lelaki
Male | <input type="checkbox"/> 1 | Perempuan
Female | <input checked="" type="checkbox"/> 2 | <input type="checkbox"/> 2 | 76 |
| 2 | Umur | 18 | — | 25 tahun/years | <input type="checkbox"/> 1 | | |
| | | 26 | — | 33 | <input checked="" type="checkbox"/> 2 | | |
| | | 34 | — | 41 | <input type="checkbox"/> 3 | | |
| | | 42 | — | 49 | <input type="checkbox"/> 4 | | |
| | | 50 | tahun ke atas
year and above | | <input type="checkbox"/> 5 | <input type="checkbox"/> 2 | 77 |
| 3 | Bangsa
Race | Melayu
Malay | <input checked="" type="checkbox"/> 1 | India
Indian | <input type="checkbox"/> 2 | Cina
Chinese | <input type="checkbox"/> 3 |
| | | | | | | Lain-Lain
Others | <input type="checkbox"/> 4 |
| | | | | | | | <input type="checkbox"/> 1 |
| | | | | | | | 78 |
| 4 | Agama
Religion | Islam
Islam | <input checked="" type="checkbox"/> 1 | Bukan Islam
Non-Islam | <input type="checkbox"/> 2 | | |
| | | | | | | | <input type="checkbox"/> 1 |
| | | | | | | | 79 |
| 5 | Taraf perkahwinan
Marital status | Berkahwin
Married | <input checked="" type="checkbox"/> 1 | Bujang
Single | <input type="checkbox"/> 2 | | |
| | | Selain dari di atas
Other than the above | <input type="checkbox"/> 3 | | | <input type="checkbox"/> 1 | 80 |
| 6 | Tahap Pendidikan Tertinggi anda
Your highest level of education | Sekolah rendah
Primary school | <input type="checkbox"/> 1 | | | | |
| | | Sekolah menengah
Secondary school | <input checked="" type="checkbox"/> 2 | | | | |
| | | Diploma (ITM TARC)
Diploma (ITM TARC) | <input type="checkbox"/> 3 | | | | |
| | | Universiti
University | <input type="checkbox"/> 4 | | | | |
| | | Tiada Pendidikan formal
No Formal Education | <input type="checkbox"/> 5 | | | <input type="checkbox"/> 2 | 81 |

7 Perkerjaan anda (jika ada)
Your job (if currently employed)

- | | |
|--|---------------------------------------|
| Professional (bekerja sendiri)
Professional (Self employed) | <input type="checkbox"/> 1 |
| Professional (makan gaji)
Professional (employed) | <input type="checkbox"/> 2 |
| Pegawai Tadbir/Pengurusan
Administrative/managerial officer | <input type="checkbox"/> 3 |
| Pegawai eksekutif
Executive officer | <input type="checkbox"/> 4 |
| Pensyarah
Lecturer | <input type="checkbox"/> 5 |
| Guru
Teacher | <input type="checkbox"/> 6 |
| Kerani
Clerk | <input checked="" type="checkbox"/> 7 |
| Polis atau tentera
Police or army | <input type="checkbox"/> 8 |
| Jurutaip/OMPD
Typist/OMPD | <input type="checkbox"/> 9 |
| Jururawat
Nurse | <input type="checkbox"/> 10 |
| Juruteknik
Technician | <input type="checkbox"/> 11 |
| Berniaga sendiri
Own business | <input type="checkbox"/> 12 |
| Bekerja sendiri
Self employed | <input type="checkbox"/> 13 |
| Buruh/pekerja tidak mahir
Labourer/unskilled worker | <input type="checkbox"/> 14 |
| Lain-lain (nyatakan)
Others (specify) | <input type="checkbox"/> 15 |

7 82

8 Di sektor/organisasi manakah anda bekerja?
In which organisation/sector do you work?

- | | | | |
|---|---------------------------------------|---|----------------------------|
| Sektor Awam
Government/public sector | <input checked="" type="checkbox"/> 1 | Badan berkanun
Semi govt agency | <input type="checkbox"/> 4 |
| Sektor swasta
Private sector | <input type="checkbox"/> 2 | Badan sukarela
Charitable organisation | <input type="checkbox"/> 5 |
| Bekerja sendiri
Self employed | <input type="checkbox"/> 3 | Lain-lain (nyatakan)
Others (please Specify) | <input type="checkbox"/> 6 |

1 8

- 9 Jika anda tidak bekerja
Adakah anda

Surirumah
Housewife/homemaker

☐ 1

Penuntut
Student

☐ 2

Pesara
Pensioner

☐ 3

belum bekerja
unemployed

☐ 4

Lain-lain (nyatakan)
Others (specify)

☐ 5

☐ 84

- 10 Selain dari di bank perdagangan, adakah anda mempunyai simpanan di lain-lain Institusi kewangan?

Ya
Yes

☐ 1

Tidak
No

☒ 2

☐ 85

Jika ya, adakah di
If yes, do you save at
(tandaakan lebih dari satu jika berkenaan)
Tick more than one where appropriate

Syarikat Kewangan
Finance Company

☐ 1

Tabung Haji
Tabung Haji

☐ 3

Syarikat Kerjasama
Cooperation

☐ 2

Lain-lain (nyatakan)
Others (specify)

☐ 4

☐ 86

11. Adakah anda melabur di Amanah Saham Nasional
Do you invest in Amanah Saham Nasional

Ya
Yes

☒ 1

Tidak
No

☐ 2

☐ 87

- 12 Sekiranya cawangan bank ini terpaksa ditutup di bank manakah anda akan pindahkan akaun anda?
If this bank branch have to be closed down, where will you transfer your account

Adakah
Will it be

di bank lain dalam kawasan ini
at a different bank in this area

☒ 1

Di cawangan lain bank ini walaupun agak jauh
at another branch of this bank even if it is quite far

☐ 2

☐ 88

- 12 (a) Tahukah anda samada terdapat cawangan Bank Islam di Kawasan ini?
Do you know if there is a Bank Islam branch in this area?

Ya
Yes

☒ 1

Tidak
No

☐ 2

☐ 89

- 13 Setujukah anda jika sebuah bank perdagangan biasa (Bukan Bank Islam) membuka satu kaunter khas untuk memberi perkhidmatan bank mengikut prinsip Islam
Do you agree if a commercial bank (not Bank Islam) opens a special counter to provide bank services according to Islamic principles?

Tidak setuju | | 1
Disagree

Tiada pendirian | | 3
No Opinion

Agak setuju | | 2
Quite agree

Kurang setuju | | 4
Quite Disagree

Setuju | - 1 | 5
Agree

[5] 90

Sila beri sebab
Please give your reason

BOLEH MENYIMPAN MENGIKUT

PRINSIP ISLAM

- 14 Pernahkah anda mendengar perkataan 'RIBA'?
Have you heard of the word 'RIBA'?

Ya | - 1 | 1
Yes

Tidak | | 2
No

[1] 91

- 15 Jika ya, pada pandangan anda adakah kadar faedah bank itu sama dengan 'riba'?
If yes, in your opinion is the bank interest similar to (the same as) riba?

Ya | | 1
Yes

Tidak | ✓ | 2
No

Kurang Pasti | | 3
Not sure

Tidak Tahu | | 4
Don't Know

[2] 92

- 16 Jika anda bekerja, berapakah jumlah pendapatan kasar bulanan anda? (dari pendapatan tetap)
If you are employed, what is your monthly gross personal income? (from fixed income)

Kurang dari \$ 400
Less than

| | 1

\$ 400 - \$ 700

| | 2

\$ 701 - \$ 1000

| ✓ | 3

\$ 1001 - \$ 1400

| | 4

\$ 1401 - \$ 1700

| | 5

\$ 1701 - \$ 2100

| | 6

\$ 2101 - \$ 2500

| | 7

\$ 2501 - \$ 3500

| | 8

\$ 3501 - \$ 5000

| | 9

Lebih dari \$ 5000
More than

| | 10

[3] 93

- 17 Lebih kurang berapa jauhakah Bank ini dari
(i) tempat anda bekerja

0 - 2 batu | ✓ | 1

3 - 5 batu | | 2

lebih 5 batu | | 3

[1] 94

- (ii) tempat anda tinggal

0 - 2 batu | | 1

3 - 5 batu | | 2

lebih 5 batu | ✓ | 3

[3] 95

